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NONQUALIFIED DEFERRED VARIABLE ANNUITIES: A PRODUCT IN SEARCH OF A COHERENT THEORY

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I. INTRODUCTION

Savings is important both for the personal economic security of the saver and for the well being of the national economy. Economists' thinking about savings has historically been dominated by the concept of intertemporal utility maximization, which has its roots in the life cycle hypothesis (LCH).[1] That model assumes that individuals are forward looking and will attempt to smooth out consumption over their lifetime independent of their level of income at any particular point. It predicts that early in life they may have low income but may borrow from the future to support their current needs, which may include buying a home, starting a family, and beginning a career. Then, sometime in mid-life their expenditure needs will level off while their income increases, hopefully exceeding their needs. It is at this point that they will pay off prior borrowings and begin to save for retirement. In retirement, their income will drop dramatically and they will use accumulated savings to support consumption needs.[2]

The empirical evidence on saving often seems to contradict the LCH. There is a large heterogeneity in household savings that cannot be explained by the traditional model.[3] In particular, there are a large number of households that are close to retirement with little or no accumulated wealth.[4]

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1. Franco Modigliani & Richard Brumberg, *Utility Analysis and the Consumption Function: An Interpretation of Cross-Section Data*, *in* POST KEYNESIAN ECONOMICS (K.K. Kurihara, ed., 1954). Modigliani and Brumberg first formally advanced the Life Cycle Hypothesis in 1954. *Id.* The hypothesis has been modified and refined over the years to incorporate the effect of bequests and precautionary savings due to uncertainty. B. DOUGLAS BERNHEIM, TAXATION AND SAVING, 29-36 (Nat'l Bureau of Econ. Research, Working Paper No. 7061, 1999).

2. *See* Gary Burtless, *An Economic View of Retirement*, *in* BEHAVIORAL DIMENSIONS OF RETIREMENT ECONOMICS 7-42 (Henry J. Aaron ed., 1999) (describing the LCH in some detail).

3. DOUGLAS BERNHEIM ET AL., WHAT ACCOUNTS FOR THE VARIATION IN RETIREMENT WEALTH AMONG U.S. HOUSEHOLDS?, (Nat'l Bureau of Econ. Research, Working Paper No. 6227, 1997).

4. ANNAMARIA LUSARDI, EXPLAINING WHY SO MANY PEOPLE DO NOT SAVE, (Center for Retirement Research at Boston College, Working Paper No. 2001-05, 2001). The author uses data from the Health and Retirement Survey (HRS), a sample of United States households whose respondents were born between 1931 and 1941. *Id.* at 5. The survey follows the households through time, reinterviewing them every two years. *Id.* The survey provides detailed information

Portfolios also vary widely across those households. Retirement assets, like Individual Retirement Accounts (IRAs) and other self-directed retirement plans, are concentrated among households whose head has at least a high school education.[5] Only a fraction of households hold stocks and bonds, and those assets are also highly concentrated among households whose head has at least a high school education.[6] A sizeable proportion of households do not hold any conventional financial assets.[7] In addition, the composition of many of their portfolios is often undiversified and not likely to produce optimal returns; as many as thirty-two percent of households have all of their financial wealth in one asset and almost half of households do not hold any of the assets that historically have delivered high returns.[8] On average, individuals who reach retirement with few assets experience a surprise—the discovery that their resources are insufficient to maintain their accustomed standard of living—and they revise their expectations downward.[9] It has been estimated that a majority of these older households will not be able to maintain their accustomed level of consumption after retirement.[10]

Whatever level of wealth a household has on reaching retirement must be managed to support consumption during retirement, a period of uncertain

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on wealth and the retirement process, with a focus on health, labor markets, economic, and psychosocial factors. *Id.*; *see also* www.umich.edu/~hrswww (providing more information on the HRS). Based on the data, the Working Paper concludes that twenty-five percent of the households in the sample have less than $30,000 in total net worth (including housing equity but not including Social security and pensions). LUSARDI, *supra*, at 6. In addition, half of the households have $6,000 or less in liquid assets. *Id.*

5. LUSARDI, *supra* note 4, at 6.

6. *Id.* at 6-7.

7. *Id.* at 7. These assets include checking and savings accounts, certificates of deposit and Treasury bills, bonds, stocks, IRAs and Keoghs, and other assets. *Id.*

8. *Id.* These assets include real estate, businesses, stocks and bonds. *Id.*

9. BERNHEIM ET AL., *supra* note 3, at 4-5. Whether this results in less happiness or life satisfaction is subject to some dispute. Some behavioral economists suggest that there is little correlation between income and happiness and that the effect of a post-retirement drop in income on retiree well being is greatly exaggerated. George Loewenstein et al., *What, Me Worry? A Psychological Perspective on Economic Aspects of Retirement*, *in* BEHAVIORAL DIMENSIONS OF RETIREMENT ECONOMICS, *supra* note 2, at 215-46.

10. *Compare* James Moore & Olivia Mitchell, *Projected Retirement Wealth and Saving Adequacy*, *in* FORECASTING RETIREMENT NEEDS AND RETIREMENT WEALTH 68 (Olivia Mitchell et al. eds. 2000) (estimating that a majority of households are not saving adequately) *with* ERIC M. ENGEN ET AL., THE ADEQUACY OF HOUSEHOLD SAVING, (Center for Retirement Research at Boston College, Working Paper No. 2000-01, 2000) (providing a more sanguine view of the adequacy of retirement savings). Using a stochastic life-cycle model, in which people save both for retirement and as a precaution against uncertain future earnings and uncertain lifespan, to generate optimal wealth accumulation benchmarks, the study concludes that a majority of households are saving adequately. ENGEN ET AL., *supra*. However, the study cautions that other interpretations are possible and admits that that there are significant warning signs of potential savings problems in the future. *Id.* (citing LUSARDI, *supra* note 4).

duration. For example, suppose a female age sixty-five decides to retire and has accumulated $1,000,000 through savings over her lifetime. How should she plan to make withdrawals from her savings so as to be certain that she enjoys the maximum possible standard of living but does not entirely exhaust the accumulated savings fund before her death?

Without access to an annuity, there is no way for her to be certain of accomplishing that goal. The level of consumption that an accumulated investment portfolio can reasonably provide is determined by investment returns, inflation, and length of life, all of which are uncertain.

With respect to the likely rate of return she will be able to earn over long periods of time, stocks have provided average annuals returns of approximately ten percent; there have been periods, sometimes of considerable length, when the return has been significantly less. For example, large company stocks lost nearly half their value between 1972 and 1974 and did not regain their 1972 level until a decade later. The current downturn that began in the spring of 2000 has been even more severe, and no one can predict when stocks may fully recover their value. Furthermore, even aside from the familiar disclaimer that past results are no guarantee of future performance,[11] focusing solely on average returns to determine the appropriate rate at which one can spend down her accumulated assets can produce misleading predictions. Retired people who begin spending down their stock portfolio at the beginning of a prolonged bear market in stocks will not be heartened by the fact that five years later the stock market recovers. They will have a significantly smaller remaining portfolio, due to five years of withdrawals at low stock prices, on which to earn the higher rates of return.

In the previous example, by investing the fund conservatively, with a large proportion in fixed income securities rather than equities, she can avoid extreme volatility in the investment returns, but she can do this only at the expense of lowering expected overall return, thereby lowering the withdrawals she can make.

Regardless of how she invests, in calculating how rapidly to spend her assets, she cannot determine exactly how long she will live. She can consult a standard mortality table[12] to determine life expectancy, but a mortality table is at best only accurate in the aggregate and cannot predict the

11. *See* PETER A. DIAMOND, CTR. FOR RETIREMENT RESEARCH AT BOSTON COLLEGE, WHAT STOCK MARKET RETURNS TO EXPECT FOR THE FUTURE (1999) (analyzing probable future stock market returns).

12. *See infra* Part III (discussing mortality tables). Her task is further complicated by the fact that there are several mortality tables she could consult that will give her different estimates of her life expectancy. *Id.*

exact life span of any one individual. For example, if she determines from a mortality table that her life expectancy is twenty years, the life expectancy of sixty-five-year-old individuals covered by that table will, on average, be twenty years. Even assuming the mortality table is accurate, only a relatively few sixty-five-year-old individuals will live precisely twenty years. About half of the individuals will die in less than twenty years while about half will live longer than twenty years, some far longer than twenty years. In fact, one currently used annuity mortality table[13] predicts that a not insignificant number of sixty-five-year-old persons will live past age 100. While our hypothetical retiree's average life expectancy may be only another twenty years, she has a very real possibility of living another thirty-five years or more.

If she begins to spend her accumulated savings on the theory that she will live exactly twenty years, she will exhaust her assets during her lifetime if she in fact outlives the average life expectancy. To illustrate, if she can expect a return of six percent per year on her savings, she can withdraw about $87,000 per year if she wants the fund to last twenty years, but she would have to reduce the withdrawals to about $69,000 per year if she wants it to last thirty-five years.

Relying on the advice of experts may also be hazardous. A recent study has concluded that the rules of thumb used by many professional financial advisors as to the appropriate rate at which retirees may spend down their accumulated wealth without undue risk of outliving their assets may in fact be much too optimistic. Instead of average rates of return, the study uses Monte Carlo simulations, which consider numerous hypothetical sequences of returns in determining maximum reasonably sustainable rates of withdrawal.[14]

On the other hand, an insurance company will accept the $1,000,000 accumulation as the premium on an annuity that will pay income each year for the rest of her life, regardless of how long she lives.[15] The key element of a life annuity is that the benefit will be paid not just for the average life expectancy of the population but for an individual's entire life, however long that may be.[16]

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13. THE COMMISSIONERS 1983 STANDARD ORDINARY ANNUITY MORTALITY TABLE. The Society of Actuaries recently approved the use of an updated table projected from the 1983 table. *See infra* note 109.

14. *See* John Ameriks et al., *Making Retirement Income Last a Lifetime*, J. FIN. PLAN., December 2001; Moshe Arye Milevsky & Chris Robinson, *Self-Annuitization and Ruin in Retirement*, 4 N. AM. ACTUARIAL J. 112 (2001) (using Canadian mortality and capital market data).

15. This is the simplest kind of annuity–an immediate, single life annuity.

16. Assuming payments will end at the annuitant's death, payments may be made for a period less than the average life expectancy of the population when the annuity payments begin.

Individually purchased annuities will be of even greater significance to future retirees. Social Security's projected long-term financial shortfall could result in a reduction in benefits to future retirees. In addition, fewer people now working are covered by "traditional" retirement plans, called defined benefit plans, that provide life annuity benefits. The majority of employment based retirement plans are now defined contribution plans that promise no lifetime benefits and place both investment risk and longevity risk on the employee.[17] It is estimated that the average retiree's balance in such plans will rise tenfold over the next thirty years and will rival Social Security as the major source of retirement wealth.[18] Furthermore, a majority of defined contribution plans do not even offer an option of annuitizing.[19] Finally, life expectancies have risen dramatically over the past fifty years and may continue to do so in the future, increasing the risk that retirees may outlive their assets.

Policymakers are concerned about the apparently inadequate levels of household savings and the increasing possibility that retirees may outlive their assets. A combination investment and insurance product, the deferred variable annuity, would seem to be the optimal prescription. A deferred variable annuity is a pre-retirement investment vehicle that permits any savings to be invested during the working years in a menu of fund options similar to mutual funds, defers income tax on any income or gain resulting from the investments until payout, and obligates the insurance company to permit the policyholder to use the amount accumulated in the policy to purchase an annuity.

Variable annuities were first offered in the United States in 1952 by the College Retirement Equities Fund (CREF), a non-profit insurer specializing in the educational retirement market, and were offered only in qualified retirement plans. It was not until the mid-1960s that nonqualified variable

17. Eric M. Engen & Andrea Lehnert, *Mutual Funds and the U.S. Equity Market*, FED. RES. BULL. 797, Dec. 1, 2000, at 803. In 1989, 40 percent of working households, with at least one employed adult, with a pension were covered by only a defined benefit plan, and another 31 percent were covered by both types of plans; only 30 percent were covered solely by a defined contribution plan. *Id.* By 1998, 57 percent of working households with a pension had only a defined contribution plan, and another 25 percent were covered by both plans; only 18 percent were covered solely by a defined benefit plan. *Id. See generally* Jack Vanderhei & Craig Copeland, *The Changing Face of Private Retirement Plans*, EBRI Brief Number 232 (April 2001) (discussing the shift in coverage).

18. James M. Poterba et al., *Saver Behavior and 401(k) Retirement Wealth*, 90 AM. ECON. R. No. 21, 297-302 (2000).

19. JEFFREY R. BROWN & MARK J. WARSHAWSKY, LONGEVITY-INSURED RETIREMENT DISTRIBUTIONS FROM PENSION PLANS: MARKET AND REGULATORY ISSUES 3 (Nat'l Bureau of Econ. Research, Working Paper No. 8064, 2001).

annuities were first offered.[20] Since then, they have experienced tremendous growth. From 1989 to 1998, the number of persons covered by these annuities grew from 2.7 million to 14.6 million. Annual premium income increased from $6.3 billion to $49.2 billion, and reserves increased from $42 billion to $354 billion.[21]

This article began as a modest research project on a technical issue involved in the taxation of nonqualified[22] deferred variable annuities, the "investor control" issue.[23] Preliminary to that research, I decided it would be appropriate to first understand the basic economic and financial aspects of annuities. What I discovered was a very complex subject that raises some very interesting and complex tax policy issues. This article is a modest attempt to outline those issues and possibly begin a dialogue about the proper tax policy treatment of nonqualified deferred variable annuities.

II. INCOME TAX TREATMENT OF NONQUALIFIED ANNUITIES

A. DEFINITION

Remarkably, the Internal Revenue Code does not provide a comprehensive definition of a nonqualified annuity. The legislative history is silent on the issue,[24] and the Treasury Regulations provide only the following:

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20. JAMES M. POTERBA, THE HISTORY OF ANNUITIES IN THE UNITED STATES 25-30 (Nat'l Bureau of Econ. Research, Working Paper No. 6001, 1997). The specific term, qualified plan, is not used in the Internal Revenue Code. Qualified plans are pension, profit sharing, and stock bonus plans that meet the specific requirements of sections 401 through 420 of the Internal Revenue Code. They are subject to many restrictions, including limitations on the amount of contributions, limitations on benefits, funding requirements, minimum participation requirements, and minimum vesting standards. In most cases, contributions to qualified plans are either deductible or excludible from the employee's income. The employee does not pay income tax until he or she actually receives distributions from the plan, even though he or she has a vested, non-forfeitable interest in the plan. There may be penalties for withdrawals before age fifty-nine and a half, and minimum distributions are ordinarily required beginning at age seventy and a half. On the other hand, nonqualified plans in which an employee has a vested, non-forfeitable interest are usually funded with after-tax dollars, but are not subject to many of the above-mentioned restrictions on qualified plans.

21. BROWN & WARSHAWSKY, *supra* note 19, at 27-28 (citing statistics from the American Council of Life Insurance *Fact Book* covering those years).

22. A nonqualified annuity is one that is not a tax-qualified plan, such as an individual retirement annuity or tax sheltered annuity, and is not owned by such a tax-qualified plan. The terminology is confusing because commercial annuities can be purchased outside of a qualified plan and also in a qualified plan. This article deals only with those annuities that are available for purchase outside of a qualified plan.

23. See *infra* Part II, Section B.3.

24. H.R. REP. NO. 83-1337, at 11 (1954); S. REP. NO. 83-1622, at 12 (1954). The only statement in the legislative history is that the annuity provision (currently section 72 of the Code) "applies to payments for a fixed number of years as well as to payments for life." H.R. REP. NO. 83-1337, at 11.

> The contracts under which amounts paid will be subject to the provisions of section 72 include contracts, which are considered to be life insurance, endowment, and annuity contracts in accordance with the customary practice of life insurance companies. For the purposes of section 72, however, it is immaterial whether such contracts are entered into with an insurance company.[25]

Because customary life insurance company practice controls with respect to most aspects of annuities, the industry has been permitted to determine for itself what features should be offered on annuity products. Some of the more salient "customary practices" of insurance companies with respect to annuity contracts are described in the next two parts of this article.

There are two kinds of annuities—immediate annuities and deferred annuities. An immediate annuity provides that payments will begin almost immediately after payment of the premium.[26] A deferred annuity provides for a longer period, referred to as the accumulation period, between the payment of the premiums and the start of annuity payments; during this time, the premiums are invested to produce an accumulation to support payments to the policyholder during the pay out phase. Since this article concerns deferred variable annuities, most of the discussion in this section will also focus on them.

B. SPECIFIC INTERNAL REVENUE CODE REQUIREMENTS FOR NONQUALIFIED ANNUITIES

In addition to qualifying as an annuity under the customary practices of insurance companies, certain Internal Revenue Code provisions contain specific requirements that must be met for a contract to be treated as an annuity for federal income tax purposes.

1. Requirements on Death of a Holder of an Annuity

An annuity contract must provide for certain distributions in the event that a holder of the contract dies.[27] The purpose of these distribution rules is to limit the period of time that an annuity may remain in the accumulation phase. If a holder

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25. Treas. Reg. § 1.72-2(a)(1) (1966).

26. It makes no economic sense to receive the first payment immediately upon paying the premium, so an immediate annuity begins payments at the end of one payment period. Thus, if the annuity is to make monthly payments, the first payment will be due one month after the premium is paid.

27. I.R.C. § 72(s) (2002). Qualified annuities and structured settlement annuities are exempt from this distribution rule. *Id.* § 72(s)(5). A holder is the person entitled to ownership rights under a contract, who is typically the named owner of the contract. If there are multiple holders, then the distribution rules apply on the death of any one of them. JOHN T. ADNEY ET AL., ANNUITIES ANSWER BOOK Q 6:6 (2nd ed. 1999) [hereinafter ANNUITIES ANSWER BOOK].

dies on or after the annuity starting date but before the entire interest in the contract has been distributed, the remaining portion must be distributed at least as rapidly as under the method being used on the date of death.[28] Thus, the post death payments may be accelerated but not slowed down.

If a holder dies before the annuity starting date—during the accumulation period with respect to a deferred annuity—then the entire interest in the contract must be distributed within five years after the holder's death,[29] with two exceptions. First, if the holder designated his or her spouse as the beneficiary, then the contract may continue after the death of the holder with the spouse treated as the new owner.[30] Second, if the holder designated an individual other than his or her spouse as the beneficiary, the distribution requirement will be met if distributions start no later than one year after the holder's death and are payable over the life of that beneficiary (or over a period not extending beyond the life expectancy of that individual).[31]

2. *Annuities Held by Non-Natural Persons*

An annuity contract held by a person that is not a natural person—a corporation or certain trusts—will not be treated as an annuity contract for federal income tax purposes.[32]

3. *Diversification and Investor Control Requirements for Variable Annuities*

Investment risk during the accumulation phase of a variable annuity is borne by the policyholder rather than by the insurance company.[33] While the original retirement variable annuity offered by CREF provided only one diversified pool of assets and no choices, the typical deferred variable annuity now offers a policyholder a choice of allocating and periodically re-

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28. I.R.C. § 72(s)(1)(A). There are special rules where the holder is a corporation or other nonindividual. *Id.* § 72(s)(6)-(7).

29. *Id.* § 72(s)(1)(B).

30. *Id.* § 72(s)(3).

31. *Id.* § 72(s)(2).

32. *Id.* § 72(u)(1). Thus, the annual income on such a contract will be treated as ordinary income received currently by the contract owner. *Id.* § 72(u)(1)(B). A contract held by a non-natural person is still treated as an annuity contract for purposes of subchapter L of the Code, which governs the taxation of insurance companies. *Id.* § 72(u)(1)(A); *see also* ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:9.

33. KENNETH BLACK, JR. & HAROLD D. SKIPPER, JR., LIFE AND HEALTH INSURANCE 879-80 (13th ed. 2001). In life insurance parlance, the premiums paid under a variable contract are placed in a separate account that supports the policy and not in the company's general account. *Id.* at 880. The company promises no particular investment results during the accumulation phase and no guaranteed level of benefits under the policy in the pay out period. *Id.* at 879-80. Rather, the benefits paid depend upon the investment results in the separate account that supports the contract. *Id.* The risk that the investment results will not be stellar is on the policyholder. *Id.*

allocating both premiums and cash surrender value among several accounts, referred to as subaccounts.[34] The number of subaccounts varies, but 15 to 30 are common.[35] The simplest product sold by CREF offers seven investment choices, including a money market fund. At the other extreme, the variable annuities sold by American Scandia Insurance Company offer over sixty choices, including a money market fund. The number and kind of investment choices available varies widely and may include general equity funds, bond funds, balanced funds, and various specialty funds, such as international funds.[36] Many annuities now also offer sector funds that concentrate in a particular area such as technology, energy, or precious metals. Some of the subaccounts are managed by affiliates of the insurer, others by independent investment advisors, and either may be based on an external index (e.g., the S&P 500) rather than being actively managed.[37] If the contract allows the owner to allocate premiums or cash values to a subaccount that invests directly in shares of a specific mutual fund, the mutual fund must not be available for purchase by members of the public other than through the purchase of an annuity contract.[38]

A variable contract based on a segregated asset account is not treated as an annuity for any period for which the investments made by that account are not adequately diversified.[39] Under the regulations promulgated pursuant to this code section, such an account is adequately diversified if no more than 55 percent of the value of the total assets in the account is represented by any one investment, no more than 70 percent by any two investments, no more than 80 percent by any three investments, and no more than 90 percent by any four investments.[40] The purpose of this rule is to preclude too

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34. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 1:21.

35. *Id.*

36. *Id.*

37. *Id.*

38. Rev. Rul. 81-225, 1981-2 C.B. 13. The IRS has issued private rulings involving subaccounts that invest in a fund-of-funds, a fund that invests in other funds. Priv. Ltr. Rul. 98-39-034 (June 30, 1998); Priv. Ltr. Rul. 98-51-044 (Sept. 22, 1998). As long as the fund-of-funds is not available for sale to the public except through the purchase of an annuity, then it may in invest in other mutual funds that are sold to the public. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:56.

39. I.R.C. § 817(h)(1) (2002).

40. Treas. Reg. § 1.817-5(b)(1)(i) (1989). All securities of the same issuer are treated as a single investment, but in the case of government securities, each government agency or instrumentality is treated as a separate issuer. *Id.* § 1.817-5(b)(ii)(A)-(B). Compliance is tested on a calendar quarter basis, and an account must be adequately diversified on or within 30 days after the end of each calendar quarter. *Id.* § 1.817-5(c); *see also* ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:55. Diversification rules also apply to regulated investment companies (RICs), which include mutual funds. Under the RIC rules, which are also applied quarterly, at least fifty percent of the assets must be represented by cash and cash items, government securities, securities of other RICs, and other securities subject to the following two limits. First, the RIC may not invest more than 5

much investor control over the underlying investments, but it is separate and distinct from the non-statutory "investor control" requirement discussed next.[41] The diversification rule does not preclude a subaccount from investing in companies solely in one market sector.

The non-statutory "investor control" requirement stems from various administrative rulings and court cases.[42] For a variable annuity to be treated as an annuity for federal income tax purposes, the separate account assets underlying the contract must be considered the assets of the insurer and not of the owner of the annuity.[43] If the owner has too much investor control, the assets will be treated as owned by her.[44] Prohibited investor control is present if the contract owner has the power to direct the custodian of the assets underlying the annuity to sell, purchase, or exchange specific assets.[45] Control may also be present if the owner has other means of influencing investment decisions.[46] There is an open question whether too large a number of subaccounts from which to choose, in itself or perhaps in combination with too little restriction on ability to shift between the various subaccounts, may constitute prohibited investor control.[47]

C. INCOME TAX RULES APPLICABLE TO DEFERRED ANNUITIES THAT MEET THE ABOVE REQUIREMENTS

While the details of the taxation of annuities are very complicated, the basic principles are straightforward. For purposes of this article, only an understanding

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percent of value of its total assets in the security of any one issuer, other than the government or another RIC, or in more than 10 percent of the outstanding voting securities of any one issuer. These limits only apply to securities falling in the 50 percent diversification portion of the RIC's assets. However, in no event may a RIC invest more than 25 percent of the value of its total assets in the securities of any one issuer, other than the government or another RIC. I.R.C. § 851(b)(3) (2002).

41. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:55.

42. *Id.* at Q 6:56.

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.* Under IRS rulings, the contract owner may not select or identify particular investments, change the terms of the investment guidelines, or have any legal, equitable, direct, or indirect interest in the underlying assets. *Id.* The contract owner may not select or communicate with the investment advisor regarding the investments underlying the contract or otherwise have any influence over the investment advisor's decisions. *Id.*

47. The problem may be even more acute if the various investment options are themselves quite narrow in scope, even though adequately diversified. The Internal Revenue Service has indicated that the non-statutory investor control doctrine has continuing vitality, separate and apart from the diversification requirements, but it has not yet proposed any regulations to delineate its scope. *Id.*

of the basic tax principles is necessary and is provided here.[48] Separate rules apply in the accumulation phase and in the pay out phase of a deferred variable annuity.

1. Accumulation Phase

Premiums paid for nonqualified deferred annuities are not excludible or deductible from income. Thus, premiums are paid with after-tax dollars. However, during the accumulation phase, the contract owner is not required to include in gross income any of the investment income that may be building up inside of the contract, including any gain realized on exchanges between subaccounts available as investment options in a deferred variable annuity.[49]

If the owner surrenders the contract during the accumulation period for its cash surrender value, he or she will include in gross income the difference between the cash received and the total premiums paid.[50] If a partial withdrawal is made from a policy, it is includible in gross income to the extent there is any yet untaxed income remaining in the contract.[51] This inclusion establishes an "income first" rule for partial withdrawals.[52] If a loan is received under an annuity contract or all or a part of the contract is pledged or assigned, the policyholder is treated as having received a distribution that is subject to these same rules,[53] as are lump sum death benefits.[54]

If an amount is included in gross income under these rules, it is treated as ordinary income, not capital gain or dividend income, and a 10 percent

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48. *See generally id.* (discussing taxation of nonqualified annuities); *see also*, A.B.A. Sec. Of Taxation Comm. on Ins. Co., *A Roadmap to the Federal Income Taxation of Nonqualified Annuity Contracts*, 45 TAX LAW. 123 (1991).

49. One major exception is that the inside build up in a deferred annuity not issued by a life insurance company will be currently taxed on an accrual basis under the original issue discount rules. I.R.C. § 1275(a)(1)(B) (2002). To be excepted from the current accrual rule, the annuity contract must provide for life contingent annuity payments. Treas. Reg. § 1.1275-1(j) (2002). Since, during the accumulation phase there is no requirement of such payments, and the contract can be cashed in for its cash surrender value without ever providing for such payments, a deferred annuity not issued by a life insurance company does not meet the statutory requirements for deferral under the regulations. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:2.

50. I.R.C. §§ 72(e)(5)(A), (E)(ii) (2002). If owners receive less than their investment in the contract, they are allowed an ordinary loss deduction. Rev. Rul. 61-201, 1961-2, I.R.B. 46. A loss is only allowed when the annuity is cashed in. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:12. Losses on exchanges between subaccounts are not currently recognized. *Id.*

51. I.R.C. §§ 72 (e)(2)(B), (e)(3)(A) (2002).

52. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:13.

53. I.R.C. § 72(e)(4)(A). The amount of the loan or the value of the portion assigned or pledged is treated as a distribution of cash and under the "income first" rule will be included in gross income to the extent of any income on the contract. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:16.

54. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:15; *see also infra* Part III (discussing death benefits).

penalty tax may also apply if the distribution is made before age 59 1/2.[55] The penalty tax is applied to insure that annuities are used primarily as retirement savings vehicles.[56]

If the holder of the contract dies during the accumulation period, then any death benefits payable to a beneficiary are not considered life insurance proceeds excludible from the beneficiary's income,[57] and the beneficiary receives no step-up in basis with respect to the contract.[58] During the accumulation phase, an annuity contract may be exchanged for another annuity contract without recognition of gain or loss.[59]

Finally, if an annuity is transferred for less than adequate consideration, then the holder is treated as receiving an amount equal to the cash surrender value of the contract minus the investment in the contract.[60] A gift is treated as a sale for the cash value of the contract and results in the recognition of all income that has built up inside the contract at the date of the transfer.[61]

2. *Pay Out Phase*

An annuity in payout status[62] must provide for the systematic liquidation of the investment in the contract and the earnings thereon.[63] A deferred

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55. I.R.C. § 72(q)(1) (2002).

56. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:18. The penalty tax does not apply to distributions that are made on or after the date the taxpayer attains age fifty-nine and one half (I.R.C. § 72(q)(2)(A)), made on or after the death of the holder (I.R.C. § 72(q)(2)(B)), attributable to the taxpayer becoming disabled (I.R.C. § 72(q)(2)(C)) that are part of a series of substantially equal periodic payments made for the life of the taxpayer or the joint lives of the taxpayer and his or her designated beneficiary (I.R.C. § 72(q)(2)(D) or under an immediate annuity contract (I.R.C. § 72(q)(2)(I)). In addition, amounts allocable to investment in the contract before August 14, 1982 are not subject to the penalty. *Id.* § 72(q)(2)(F).

57. Rev. Rul. 55-313, 1955-1 I.R.B. 219; ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:15.

58. Rev. Rul. 79-335, 1979-2 C.B. 292, *revoking* (for contributions made after October 21, 1979) Rev. Rul. 70-143, 1970-1 C.B. 167. Thus, the beneficiary receives a carry over basis, which will be used to compute her exclusion ratio under section 72. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:15. Assets owned in non-retirement accounts at death generally receive a basis in the beneficiary's hands equal to their fair market value on the date of death, so any unrealized capital gains will never be subject to income tax. I.R.C. § 1014(a)(1) (2002).

59. I.R.C. § 1035(a)(3) (2002).

60. I.R.C. § 72(e)(4)(C)(i) (2002). There is an exception for certain transfers between spouses or former spouses. I.R.C. § 72(e)(4)(C)(ii).

61. On the other hand, gifts of non-annuity assets generally are not treated as sales. I.R.C. § 1015 (2002). Any gain remains unrealized and shifts to the donee, who takes the donor's basis for purposes of computing gain. *Id.*

62. I.R.C. § 72(c)(4). An annuity is in payout status on the annuity starting date, which is the first day of the first period for which an amount is received as an annuity under the contract. *Id.* Amounts received as an annuity are amounts received under an annuity contract on or after the annuity starting date that are payable at regular intervals over a period of more than one full year from the date on which they begin to be paid, provided the total amount so payable or the period

variable annuity policyholder may choose either a fixed or variable annuity at payout and may choose payments for a stated term of years or for a term that depends on how long the annuitant lives—a life contingent annuity.

The payments under a fixed annuity, also referred to as a nominal annuity, are computed at the start of the payout period and do not change thereafter. Under a fixed annuity, the insurance company bears the entire investment risk[64] in addition to the mortality risk if the annuity is a life contingent annuity.

The payments under a variable annuity are not fixed, but rather will change according to the investment results of the assets that back the contract. A variable annuity with life contingencies places the mortality risk on the company and the investment risk on the policyholder.[65] A variable annuity without life contingencies places both risks on the policyholder.[66]

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for which they are to be paid is determinable at that time. Treas. Reg. §§ 1.72-1(b), -2(b)(2) (1963). The amounts are required to be determinable either directly from the terms of the contract or based on mortality tables and compound interest projections in accordance with sound actuarial theory. Treas. Reg. § 1.72-1(b)(2)(iii). They are typically paid over a single life or joint lives, over a fixed period, in an amount certain, or in some combination of these options. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:19.

63. Ingleheart v. Commissioner, 174 F.2d 605 (7th Cir. 1949); Commissioner v. Myer, 139 F.2d 256 (6th Cir. 1943); Rev.Rul. 75-255, 1975-2 C.B. 22. If an amount is held under an agreement to pay interest, the interest payments are fully included in gross income. I.R.C. § 72(j); Treas. Reg. § 1.72-14(a) (1960); *see also* ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:2.

64. BLACK & SKIPPER, *supra* note 33, at 879-80. When the insurance company receives the premium under a fixed annuity, the premium becomes part of its assets. *Id.* In life insurance parlance, it goes into the company's general account. *Id.* The company will invest the premium, after it has paid policy expenses, and attempt to earn a rate of return at least sufficient to pay the benefits it promised under the contract. *Id.* Any return the company earns above the amount it has agreed to pay the policyholder becomes part of the company's profits, but if it does not earn a return sufficient to pay the promised benefits, the company must make up the shortfall out of its other assets in the general account. *Id.* Thus, the company bears the investment risk and reaps any investment rewards under a fixed annuity. *Id.*

65. The initial payments under a variable annuity are computed using an assumed rate of return, and future payments are adjusted upward or downward based on the actual return on the funds backing the contract. If the actual return exceeds the assumed return there is an upward adjustment; if the actual return is less than the assumed rate of return, there is a downward adjustment. The exact adjustment is computed under a precise mathematical formula that results in adjustments that are actuarially fair to the annuitants. An assumed rate of four percent is normally chosen because it provides a reasonable probability that there will be future increases in the annuity payment if the assets backing the annuity are not invested too conservatively. There is no guarantee that payments will not decrease in any given year or even over a very long period of time.

66. *See* Thomas A. Campbell & Timothy J. Ruark, Remarks at the 1998 Valuation Actuary Symposium Proceedings, Session 10PD, Actuarial Guideline XXXIV/Minimum Guaranteed Benefits for Variable Annuities (discussing guaranteed lifetime benefits, including the GPAF, and guaranteed death benefits). A major risk of any variable annuity is that the payments can go down with no limit. This risk may be lessened by a benefit provided by some insurers, the Guaranteed Payout Annuity Floor (GPAF), which guarantees that the payment will not decrease below a certain level.

Regardless of which option is chosen, a portion of each amount received as an annuity is included in gross income and the remainder is excluded from gross income as a tax-free return of basis. The entire amount included in gross income is treated as ordinary income; no portion of it is treated as capital gain or dividend income.[67] The computation of the amount excluded is governed by a statutory exclusion ratio.[68] For any level payment fixed annuity and for all variable annuities, the exclusion ratio essentially permits policyholders to exclude their investments in the contract ratably over the number of years that payments are expected to be made.[69] Once policyholders recover their entire investment in the contract, all amounts thereafter received are included in their gross income.[70]

If amounts are received during the payout period that are not amounts received as an annuity—policy dividends in excess of the guaranteed

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67. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:3.

68. I.R.C. § 72(b) (2002). The exclusion ratio is a fraction the numerator of which is the investment in the contract and the denominator of which is the expected return under the contract, both computed as of the annuity starting date. The investment in the contract is the aggregate amount of premiums paid less any amounts received prior to the annuity starting date that were excluded from gross income. I.R.C. § 72(c)(1). If the annuity contract provides for payments to a beneficiary on the death of the annuitant, in the nature of a refund of the consideration paid for the contract, then the investment in the contract to be recovered by the annuitant tax free is reduced by the value of the refund feature. I.R.C. § 72(c)(2). The value of the refund payments is determined under actuarial tables provided in the regulations and without discounting for interest. Treas. Reg. § 1.72-7 (as amended in 1986). Presumably, the beneficiary may recover that amount tax-free. The regulation provides that the beneficiary may also recover any portion of the remaining investment in the contract that is not recovered by the annuitant during life by application of the exclusion ratio. Treas. Reg. § 1.72-11(c)(2), Example (1) (as amended in 1986). The expected return is the sum of all payments expected to be received under the contract as an annuity. I.R.C. § 72(c)(3). If that amount depends on life expectancy, it is computed under actuarial tables of life expectancy provided in the regulations. The actuarial tables in the regulations used in computing the exclusion ratio are not the same actuarial tables used by the company in pricing the product. Treas. Reg. § 1.72-9 (as amended in 1995). In general, the regulation tables assume a life expectancy more appropriate to the general population than to the select group of annuity purchasers. This assumption has the effect of permitting a faster tax-free recovery of investment premiums than would the use of the longer life expectancies reflected in the annuity mortality tables used by insurers. A more detailed discussion of annuity mortality tables is provided later in this article.

69. In the case of a variable annuity payout, since the total expected return cannot be computed, the regulations provide that the investment in the contract will be recovered ratably. Treas. Reg. §§ 1.72-2(b)(3) (as amended in 1966), 1.72-4(d)(3) (as amended in 1987). Thus, if annuity payments are expected to be received under a variable annuity for twenty-five years, then the amount of each yearly payment to be excluded each year is 1/25 of the investment in the contract. If that amount exceeds the total payment received in that year, the taxpayer is given an election to recalculate the exclusion under a different method. Treas. Reg. §§ 1.72-4(d)(3)(ii), (d)(3)(iv); ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:26.

70. I.R.C. § 72(b)(2). Prior to the Tax Reform Act of 1986, the exclusion ratio to all payments, resulting in total exclusions exceeding the investment in the contract, but if the policyholder died before recovering the entire investment, he or she was not allowed any loss deduction.

interest with respect to a participating annuity—those amounts are fully includible in gross income.[71]

In the case of either a fixed or variable annuity, if the annuitants die before recovering their entire investment in the contract and payments cease at death, they are allowed a loss deduction for the remaining unrecovered portion of their investment in the contract on their final income tax return.[72]

D. COMPARISON OF TAXABLE MUTUAL FUNDS AND DEFERRED VARIABLE ANNUITIES

One of the ongoing debates is whether variable annuities are merely tax-advantaged mutual funds, so an investor who does not value their annuity aspects could purchase them as an attractive substitute for mutual funds because they would deliver a greater after-tax return.[73] While deferred annuities are tax-advantaged in some respects as compared with other investments, most notably because taxation of income and gain is deferred until payout, in other respects they are not.

Several tax and non-tax factors favor investing outside of annuities. Mutual funds have no early withdrawal tax penalties and most have no surrender charges.[74] Significant tax deferral is possible by investing in tax efficient equity mutual funds, such as index funds, that do not have high portfolio turnover and therefore do not realize capital gains that are currently taxable, and much of the gains realized on equity mutual funds are long-term capital gains or dividend income, which are taxed at preferential income tax rates. Any capital losses realized by an investor on the sale or exchange of mutual fund shares are currently recognized and provide immediate potential tax benefits. Mutual funds also provide more flexibility in personal financial planning: they may be transferred by gift without recognition of gain; they may be pledged as security for loans

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71. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:25.

72. I.R.C. § 72(b)(3). If payments do not cease at her death, then the deduction (if any) is allowed to the beneficiary who is entitled to receive the post death payments. I.R.C. §§ 72(b)(3), (4); *see also* ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:32. Until the amendments to section 72 in the Tax Reform Act of 1986, an annuitant could apply the exclusion ratio to all payments received as an annuity (even if the payments extended beyond her life expectancy) and therefore could exclude a total amount in excess of her investment in the contract. However, under the pre-1986 law, if she died without recovering her entire investment, no loss deduction was allowed.

73. *See* Moshe Arye Milevsky & Kamphol Panyagometh, *Variable Annuities vs. Mutual Funds: A Monte Carlo Analysis of the Options*, IFID CENTRE RESEARCH REPORT #01-03 (The Individual Fin. & Ins. Decision Centre, Toronto, Ontario, Canada), Dec. 31, 2001. The paper compares investment returns in variable annuities with those in taxable mutual funds using Monte Carlo simulations. *Id.* It also surveys the existing literature on the subject. *Id.*

74. Mutual funds do not in general have surrender fees, but some funds do levy exit fees to discourage short-term trading.

without causing recognition of gain; and if held at death, they receive a step-up in basis to fair market value on the date of death, eliminating any unrealized capital gains at death.[75] Most deferred annuities also have higher expense charges than mutual funds and insurance charges that most mutual funds do not, and they levy surrender charges in the first several years of ownership.

The major tax advantage that annuities have is that income or gains are not taxed until payout, while any gains realized by a shareholder who sells her shares in a mutual fund and any income or gain realized by a mutual fund is immediately taxed even if it is reinvested in the fund. So a deferred annuity is a very attractive vehicle for active traders or speculators who make frequent transfers between subaccounts because of the deferral of taxation of short-term gains on such exchanges that would otherwise be currently taxed at high rates.

As an investment vehicle for long-term investors, deferred variable annuities most resemble taxable mutual funds if held by someone over age 59 1/2 and after any surrender charge period on the variable annuity has expired. However, it takes a number of years for a variable annuity to overcome its higher expenses and the higher tax rate that is levied on annuity gains to produce net returns comparable to a mutual fund if it is cashed in. A recent study, based on Monte Carlo simulations, concluded that the break-even point is at least ten years if the comparison is between low-cost mutual funds and low-cost variable annuities, but the break-even point is over thirty years in the case of a typical high cost variable annuity.[76] The study assumes that the purchaser is using the variable annuity only to obtain tax-deferral and will eventually cash it in, pay the income tax due, and consume the remainder. For the high cost scenario, the study assumes that the average expenses on the variable annuity are 2.07 percent per year with an annual contract charge of $30, and the management expenses on the mutual fund are 1.41 percent;[77] while for the low cost scenario, it assumes

75. *See supra* note 58 (discussing transmission at death) and note 60 (discussing transmission by gift).

76. Milevsky & Panyagometh, *supra* note 73. The study concludes that the basic error of prior studies that showed a shorter break even point was that they assumed a constant rather than a stochastic rate of return and that they ignored the ability of the mutual fund investor to obtain current tax benefits by recognizing losses but not gains. *Id.* The study was based on tax rates in effect prior to the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003, which lowered all tax rates, including the preferential rate on long-term capital gains, and for the first time, it applied the same preferential rate to dividends paid by most domestic corporations. It would take even longer for a variable annuity to break even with a similar investment in a taxable mutual fund if the new, lower rates are taken into account.

77. *Id.* These are based on average total expenses for variable annuities and mutual funds. *Id.* at 11.

total expenses of .3 percent for the annuity and .2 percent for the mutual fund.[78] The results of the study imply that a typical high cost deferred variable annuity is an inferior investment to taxable mutual funds for older individuals who purchase the annuity solely or primarily for its investment aspects and who do not intend to annuitize it, since they may well not survive to the break even point.

Furthermore, regardless of where the break-even point may be for someone who purchases an annuity primarily for investment purposes as a substitute for a mutual fund, it is only one factor relevant to the comparison. Whatever intention purchasers may initially have, the future is uncertain. They may die before cashing in the policy, have a change of circumstances that necessitates early withdrawals or a need to borrow, or later determine that they wish to make a gift of their interest to other family members. The negative tax attributes of annuities—lack of step-up in basis at death, possible early withdrawal penalties, triggering of gain on gift transfers and pledges—are significant and severely restrict financial planning flexibility. They make a deferred annuity an inferior investment vehicle for almost anyone who purchases it solely for investment purposes and who does not value its annuity pay out options.

E. SHOULD NONQUALIFIED DEFERRED VARIABLE ANNUITIES BE SPECIALLY TAXED?

The special tax status of deferred variable annuities is based on the assumption that they provide significant welfare benefits not provided by other nonqualified retirement savings and investment vehicles, but there has never been any detailed analysis of whether that assumption is warranted. The various aspects of the product complicate the analysis: it is designed not only as a retirement payout vehicle, but also as a savings and investment vehicle. Certain of its features are unique to deferred annuities while others are similar to features of other nonqualified products, most notably mutual funds. The investment and payout phases are also intertwined because during the payout phase, the accumulated funds must continue to be invested and managed to provide an adequate stream of retirement income.

The next two parts of this article separately analyze in detail first the payout phase and then the accumulation phase of deferred variable annuities

78. *Id.* at 11. In the low cost scenario, it was assumed that the low cost mutual fund was not tax efficient—not managed to minimize shareholder tax liability. *Id.* If a low-cost, tax-efficient fund, such as an index fund, were used for the simulation study, the time needed to break even would be longer. *Id.* at 20.

as they are currently designed to determine whether they provide significant enough welfare benefits to clearly distinguish them from other nonqualified retirement savings vehicles and justify their preferred tax status. Based on these analyses, the final part suggests appropriate changes in the design and taxation of deferred variable annuities.

III. ANNUITIZATION ASPECTS OF DEFERRED VARIABLE ANNUITIES

A. INTRODUCTION

To qualify as an annuity, the contract must not be designed merely for accumulation of assets, but rather for the eventual liquidation of the accumulated funds through a payment or a series of payments over some period of time. One major reason deferred variable annuities are tax-advantaged is because of their annuity payout aspects. Indeed, it is those payout aspects that most clearly distinguish deferred variable annuities from other nonqualified retirement savings vehicles.

Specific terms of the contract determine when the annuity payments begin under a deferred annuity. To insure that the policy is operating as an annuity rather than a mere savings or investment account, the contract will usually provide the date that annuity payments will begin, but the contract will permit the annuitant to change that date with proper notice to the company. The limit on how long an annuity may remain in the accumulation stage varies with state law but most state laws permit deferral until very advanced ages.[79]

The series of payments may be for a fixed term[80] or for a term that depends on how long the annuitant lives.[81] While an annuity for a fixed

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79. At one time, the annuity starting date used by commercial insurance companies was usually no later than the annuitant's eighty-fifth birthday or ten years after purchase of the contract if later. Recently, because of increased longevity, many deferred annuities have allowed later starting dates, as late as the nineteenth birthday. Some states, such as New York, impose restrictions on how long the deferral may last. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 1:15.

80. An annuity without life contingencies provides for a series of payments that will last for a specific period of time and will cease at the end of that period. There appears to be no limit on how long a fixed period can be chosen, but many policies do not permit fixed periods in excess of thirty years without the company's permission. An unduly long fixed period, one that far exceeds the life expectancy of the annuitant, may present problems. After all, an annuity should be designed to provide lifetime benefits to the annuitant, not used as a bequest device. There is no definitive law on the issue.

81. A life annuity provides for payments over an indeterminate period of time measured by the lifetime of one or more individuals. A single life annuity is paid for the life of one individual; while a joint and last survivor annuity provides for payments for as long as any one of two or more individuals is living. A joint and last survivor annuity may provide for a full benefit to the

term is valuable because it provides some protection against dissipating one's assets before the end of the fixed term,[82] it provides no protection against outliving one's assets. Only a life annuity provides a guarantee that payments will not cease until death.

A nonqualified deferred variable annuity gives the policyholder an option to choose an annuity, either for a fixed period or life contingent, as the pay out option. However, an important element of the analysis of the welfare benefits the product provides is that no form of annuitization is required: the policyholder may also choose to withdraw the funds in other ways, including cashing the policy in for a single lump sum. Life annuitization is entirely voluntary. Therefore, the magnitude of the welfare benefits of the annuitization aspects of a deferred annuity can only be measured by determining how many policyholders can reasonably be expected to voluntarily choose to annuitize.

B. THE ECONOMIC VALUE OF LIFE CONTINGENT ANNUITIES

1. Introduction

Economic theory predicts that the insurance against outliving one's assets provided by life contingent annuities is so valuable to a consumer without bequest motives that he or she should choose to completely annuitize his or her assets.[83] A recent study highlights the value of annuities in addressing the mortality uncertainty faced by individuals and concludes that consumers should be prepared to give up substantial amounts of their wealth to purchase life annuities.[84] For example, it was computed that individuals should be willing to accept a reduction of

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survivor(s) or some lesser amount—2/3, 3/4, etc. There is also a joint life annuity, under which the payments cease on the death of the first covered life, but these are rare. BLACK & SKIPPER, *supra* note 33, at 163.

82. An annuity for fixed term does not provide complete protection against dissipating assets because the insurance company may permit the annuitant who chooses a fixed term annuity to surrender the contract for a cash payment equal to the market adjusted value of the remaining annuity payments. *See generally* Timothy C. Pfeifer et al., Session 138 PD, An Immediate Annuity With Cash-Out Rights?, Panel Discussion Before the Washington Annual Meeting of the Society of Actuaries, (Oct. 26-29, 1997), *in* 23 RECORD No. 2 (discussing annuity cash out rights). Life annuities are not generally cashable, since the vast majority of those who would seek to cash out would be those who ascertained that their life expectancy had significantly decreased, resulting in losses to the insurance company.

83. Menahem E. Yaari, *Uncertain Lifetime, Life Insurance, and the Theory of the Consumer*, 32 REV. OF ECON. STUD. 137, 145 (1965).

84. Olivia S. Mitchell et al., *New Evidence on the Money's Worth of Individual Annuities*, 89 AM. ECON. REV. 1299, 1300 (1999). The study uses actual annuity rates offered by life insurance companies. *Id.* at 1304. It computes what is called the Annuity Equivalent Wealth (AEW), a measure of how much wealth an individual would be willing to give up for access to an actuarially fair annuity. *Id.* at 1313-14.

between 30 and 38 percent of their wealth at age 65 if they are able to purchase annuities rather than pursue an optimal consumption strategy without annuity contracts; a hypothetical retiree with access to an annuity would require approximately $700,000 at age 65 to finance his or her retirement to produce the economic equivalent of pursuing the same consumption strategy by trying to manage a $1,000,000 retirement fund without access to an annuity.[85]

Intuitively, individuals require a greater amount of wealth without an annuity than with an annuity to support the same consumption stream because without an annuity they must self-insure against the risk of longevity. That requires more conservative spending and the possibility of making unintended bequests if they do not outlive their life expectancy. With a life annuity, each annuity payment may safely be spent on current consumption without the risk of outliving one's assets.

2. *Mortality Premium*

One obvious risk of pure life annuities is that the annuity payments cease at the death of the annuitant. To compensate the annuitant for taking that risk, each payment in a life annuity stream contains a mortality premium. Since one is less likely to survive to later ages, the mortality premium on later payments in an annuity stream is greater than that on the earlier payments. As discussed later, mortality tables are used to compute the mortality premium factors.[86] Because of the mortality premium, the payments under a life annuity are greater than those under a fixed term annuity payable over the actuarially computed life expectancy of the annuitant. This economic enhancement, together with the assurance that

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85. *Id.* at tbl. 6. There are a number of variables that affect any people's determination of what portion of their wealth they are willing to give up in exchange for access to an actuarially fair annuity, including their risk tolerance, inflation assumptions, the rate of return they could earn on her own non-annuitized assets, whether taxes are taken into consideration, and whether people are assumed to already have a preexisting real annuity, like Social Security benefits. Table six in the study provides calculations of annuity equivalent wealth in varying scenarios. *Id.* In all scenarios, the computations indicate that the insurance benefits of annuities have very substantial value to the average individual. *Id.*; *see also supra* note 14 (noting studies detailing the difficulty of self-managing one's assets so as to maximize consumption without unduly risking outliving one's assets).

86. *See* BLACK & SKIPPER, *supra* note 33, at 730-32 (explaining the computation process). The mortality premium in each payment is equal to the probability, computed at the date the annuity is purchased, that the policyholder will not survive to receive that payment. *Id.* It adequately compensates the policyholder for the risk taken only if the mortality table used to price the annuity accurately reflects the survival probabilities. *Id.* An annuity priced to accurately reflect the survival probabilities of the insured population is said to be priced actuarially fair to that population. *See infra* Part III, section C.2 (discussing the accuracy of the annuity mortality tables).

life annuity payments will not cease until death, should make life annuities a very attractive alternative to other pay out options.

3. *Alleviating Risk of Loss*

While a life annuity protects individuals against outliving their life expectancy, there is also a risk that the annuitant will die prematurely. In that event, the annuity will turn out to have been a poor investment choice. The mortality premium, if it accurately reflects the annuitant's survival probability, compensates an annuity purchaser for assuming this risk, but some individuals also seek ways to reduce the magnitude of the risk.

Contractual guarantees are one method to lessen the risk. Instead of being completely life contingent, an annuity can guarantee that at least a certain number of payments will be made, either to the annuitant, or if he or she dies within the guarantee period, to a beneficiary. For example, a life annuity with a ten-year guarantee would provide for payments for a minimum of ten years and for the remaining life of the annuitant if he or lives longer than ten years. The annuity payments for a life annuity with a guaranteed period will be lower than the annuity payments for a similar annuity with no guarantee.[87]

The risk of loss due to premature death can also be reduced through the use of joint and survivor annuities and by "front loading" annuity payments.[88] Joint and survivor annuities provide for payments to the survivor in the event of death of one the annuitants.[89] The premature death of one of the annuitants will not be as catastrophic as premature death of the annuitant who purchases a single life annuity since payments will continue to the survivor. However, the payments under a joint and survivor annuity will be less than those under a single life annuity. Front loaded annuities provide for higher payments in the earlier years when mortality risk is lower.

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87. BLACK & SKIPPER, *supra* note 33, at 730-31. The payments are lower because there is no mortality premium on the annuity payments during the guaranteed period since there is no risk that those payments will cease due to death. *Id.* The guarantee can also be in the form of insuring that the total payments made will at least equal the premium paid. That guarantee can either require a lump sum payment of the difference to the beneficiary or continuing payments to the beneficiary until the total payments at least equal the premium.

88. *See* JEFFREY R. BROWN, CTR. FOR RETIREMENT RESEARCH AT BOSTON COLLEGE, HOW SHOULD WE INSURE LONGEVITY RISK IN PENSIONS AND SOCIAL SECURITY? 16 (2000). The paper discusses the possible negative effects of mandatory annuitization of pension benefits and Social Security, but similar negative effects may result from voluntary annuitization of other retirement assets, such as deferred variable annuity accumulations. *Id.*

89. There are a variety of joint and survivor annuities. *See supra* note 81.

4. Unique Value of Variable Annuity Payments

While a variable annuity payout does place annuitants at risk of market fluctuations, the risk is different from that faced by a person drawing down his or her own wealth without an annuity. Unlike that person, who cannot rely upon average rates of return, the variable annuitant can. Non-annuitant retirees take the risk that they will have exhausted too great a percentage of their assets during a prolonged market downturn and might entirely deplete their assets before they had planned. That risk is not present for annuitants with guaranteed payments for their lifetime. A prolonged bear market may significantly lower their income, but the income will never cease until death, and if they survive until the market fully recovers, then so will the level of annuity income. This is one of the more attractive aspects of a variable annuity: it permits annuitants to maintain exposure to the volatile equity markets and benefit from their probable higher rates of return over long periods of time without the risk of outliving their assets.

C. RESISTANCE TO ANNUITIZATION

1. Introduction

Contrary to economic theory, individuals do not voluntarily annuitize their assets at anywhere near the predicted level. In fact, historically the market for individual life annuities in the United States has been extremely small.[90] Likewise, annuitization rates of deferred annuities have been extremely low. From 1971 to 1996, the percentage of policyholders receiving payments has ranged from .6 percent to 1.9 percent, with the most recent rate at 1.1 percent.[91] Since most of these policies were still owned by policyholders who are still working, these figures probably understate the likely annuitization rates in the future, but by how much is not ascertainable. More than half of the owners were retired as of 2001, and there is no evidence that annuitization rates have changed.[92]

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90. Mitchell, et.al., *supra* note 84. The authors cite statistics, provided by LIMRA International, that single premium immediate annuities accounted for only $6.2 billion of premium payments in 1995. *Id.* at 1301.

91. *See* BROWN & WARSHAWSKY, *supra* note 19, at 28.

92. The Committee of Annuity Insurers has sponsored an annual Gallup survey of owners of nonqualified annuity contracts since 1991. According to the 2001 Gallup survey, fifty-six percent were retired and another seven percent were employed only part time. GALLUP ORG., 2002 SURVEY OF OWNERS OF NONQUALIFIED ANNUITY CONTRACTS 8 (2001), *available at* www.annuity-insurers.org/srvyo1.5html (last visited Oct. 27, 2003) [hereinafter 2001 GALLUP SURVEY]. Only thirty-one percent were still employed full time. *Id.* In addition, sixty-nine percent of variable contract owners, versus fifty-three percent for other owners, have not withdrawn money or received a regular payout from their policies. *Id.* at 16.

A recent study[93] identified a number of factors that may explain the general reluctance of individuals to annuitize their retirement wealth. These factors include the following: the fact that individual annuity markets do not offer actuarially fair prices; the lack of inflation protection in commercially available annuities; health uncertainty and the irreversibility of annuitization; the presence of other sources of annuity income, for example, Social Security; bequest motives and risk sharing within families; and general lack of consumer understanding of annuitization. There are also specific factors that may inhibit the annuitization of deferred variable annuities, including psychological resistance, the incentives of insurers with respect annuitization of deferred variable annuities, and the probable behavioral effects of deferred annuity death benefits.

2. *Lack of Fair Prices for Individuals with Average Life Expectancy: Adverse Selection*

With regard to the pricing of annuities, the above study concluded that payouts on immediate annuities offered by commercial insurers in 1999 were approximately eight to ten percent lower than the actuarially correct payout for a purchaser with mortality rates like those of the general population.[94] The adverse selection problem arises with respect to all insurance products.[95] It is the tendency of persons who have reason to expect they will receive greater benefits than average to be more likely to purchase an insurance product that is priced for a person of average risk.

For example, if an insurance company accepts all applicants and prices its life and health policies based on the mortality and morbidity rates in the general population, without underwriting, its price will not be adequate to compensate for the risks assumed because very likely an inordinate number of prospective policyholders would be those who had already developed serious illnesses or disease. If universal coverage of the entire population is not somehow mandated, the presence of free choice among prospective purchasers of life and health insurance as to whether or not to purchase a policy almost guarantees that there will be adverse selection.[96]

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93. BROWN & WARSHAWSKY, *supra* note 19. The paper discusses the reluctance of individuals to fully annuitize assets in qualified retirement plans, but many of the identified factors may also explain the reluctance of individuals to annuitize accumulated assets that are not in qualified plans. *Id.*

94. *Id.* at 7 (citing JEFFREY BROWN ET AL., MORTALITY RISKS, INFLATION RISKS, AND ANNUITY PRODUCTS, (Nat'l Bureau of Econ. Research, Working Paper No. 7812, 2000).

95. BLACK & SKIPPER, *supra* note 33, at 636-39 (discussing adverse selection).

96. *Id.* Adverse selection also applies to already existing policyholders by affecting the persistency of existing polices. *Id.* While all policyholders have the option of discontinuing, healthy policyholders are much more likely than sick individuals to terminate their existing life or health

In the health and life insurance area, an insurance company attempts to lessen the consequences of adverse selection through underwriting, by asking specific questions of prospective purchasers, and in some cases requiring medical tests. The company may have several categories of policies that have different premium rates. The company may also deny coverage to individuals who are substandard. Underwriting is a highly sophisticated and complicated process,[97] but it is not totally effective, since applicants will not be completely candid and it would be too costly to acquire all possible information about an applicant. Underwriting does serve to detect and deter adverse selection in the life and health insurance area and permits insurers to offer competitive insurance rates.

Adverse selection is also a problem with respect to annuities in the opposite sense: the company is concerned with applicants who have a longer than average life expectancy. Individuals who are already sick with a chronic or terminal disease do not purchase annuities;[98] therefore the universe of annuity purchasers, especially at higher ages, tends to have better mortality experience than the population in general and even than the population of preferred risk life insurance purchasers.[99] Unlike in the health and life insurance area, where the company may deny coverage entirely to an applicant who is too substandard, no company will deny annuity coverage to an applicant who has too long a life expectancy. Instead, a company will assume that a prospective annuity purchaser has self-selected himself or herself and has a higher than average life expectancy. A company will use mortality tables in connection with pricing its annuity business that will show more conservative mortality rates than those used in connection with its life insurance business and more much more conservative than those of the population at large.[100]

Instead of underwriting the mortality risks of prospective annuity purchasers and having different premiums for different identifiable risk groups, almost all insurance companies assume that annuity purchasers are a homo-

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policies, leaving the insurer with a higher than anticipated proportion of high risk policyholders. *Id.* at 637.

97. *See* BLACK & SKIPPER, *supra* note 33 at 633-92 (discussing underwriting).

98. BLACK & SKIPPER, *supra* note 33, at 173. An exception is the structured settlement annuity, which is separately underwritten by insurance companies. *Id.* A structured settlement is an annuity paid to an injured person as the result of a personal injury claim. *Id.* Since such persons clearly exhibit substandard mortality experience and because of competitive factors, the companies have underwritten and specially priced this line of business. *Id.*

99. *Id.* at 704.

100. In the annuity context, a more conservative mortality table shows lower rates of mortality.

geneous group with low mortality rates.[101] An insurance company will generally use only two annuity mortality tables, one for males and one for females.[102]

The differences in life expectancy in the population as a whole, in the life insurance purchaser population, and in the annuity purchaser population can be significant. A sixty-five-year-old male in the general population has a life expectancy of approximately 15.5 years.[103] For life insurance purposes, typical insurance mortality tables use a life expectancy of 18 years[104] and for annuity purposes at least twenty-four years. To illustrate the difference, with a 6 percent rate of return, a person could invest the sum of $100,000 and withdraw about $10,100 per year if he or she wished the fund to last exactly 15.5 years, about $9,200 per year if she wished the fund to last exactly 18 years, and only about $8,000 per year if she wished the fund to last 24 years.

If an insurance company's annuity rates are not actuarially fair to a purchaser who has a life expectancy commensurate with that of the general population, they are even less fairly priced for persons whose mortality rates can be predicted to be even higher than the rates in the general population. Recent studies have investigated how life expectancy varies with race, ethnicity, and education and suggest that some minorities and those

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101. Separate tables have been developed for smokers and non-smokers, but only one company has offered an annuity to smokers based on that table. BLACK & SKIPPER, *supra* note 33, at 705. Some believe that this raises moral hazard issues, since in some sense the smoker is being "rewarded" for smoking by being able to purchase an annuity with higher payout rates due to the lower life expectancy caused by smoking. Also, since such a policy would require the prospective policyholder to adhere to a certain level of smoking to get the preferred rates, it might be thought of as discouraging quitting smoking.

102. Two Supreme Court decisions mandate equal benefits for men and women under qualified defined benefit retirement plans. City of Los Angeles Dep't of Water & Power v. Manhart, 435 U.S. 702 (1978); Arizona Governing Comm. for Tax Deferred Annuity and Deferred Comp. Plans v. Norris, 463 U.S. 1073 (1983). In *Manhart*, the Court held that employer provided pension plans may not require female employees to make larger contributions than males to receive the same monthly benefits. *Manhart*, 435 U.S. at 709. The Court compared the practice of pricing annuities differently for men and women to classifying employees by race or national origin and basing compensation on the differential life expectancies of those groups. *Id.* In *Norris*, the Court held that equality between the sexes was also required in deferred compensation plans sponsored by the employer but administered by an outside company. *Norris*, 463 U.S. at 1081. The Court's decision requires that if an employer contracts with an insurance company to administer its plan through annuity purchases, the plan must provide equal annuity benefits to male and female participants. *Id.* There is no similar unisex requirement for nonqualified annuities.

103. This is based on the 2000 Period Life Table published by the Social Security Administration.

104. Life insurance companies also do not use the lower life expectancies predicted by the Social Security Administration's tables in pricing life insurance because many individuals in the population with the lowest life expectancies do not purchase life insurance. Thus, since life insurance mortality tables are based on the population of likely purchasers, they tend to exclude those in the general population at the lowest end of the life expectancy scale.

with low levels of education may have lower than average life expectancies.[105] There is also evidence that persons in a higher socioeconomic group tend to live longer, but the issue is complicated because there is no definitive way to measure the effects.[106]

This problem may become more acute in the future if medical science develops new methods of predicting susceptibility to certain diseases. The better members of the general population are able to objectively judge their own particular mortality characteristics, the more pronounced the adverse selection problem will be for insurers, which will be forced to become even

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105. JEFFREY R. BROWN, DIFFERENTIAL MORTALITY AND THE VALUE OF INDIVIDUAL ACCOUNT RETIREMENT ANNUITIES, 4-6 (Nat'l Bureau of Econ. Research, Working Paper No. 7560, 2000). Professor Brown cites evidence that mortality rates of African Americans are higher than those of Caucasians at all ages below seventy-five, but there is also conflicting evidence that at older ages there may be a crossover—African American life expectancy higher than Caucasian. *Id.* at 4-5. He also sites available evidence that Hispanics have lower life expectancies than Caucasians, despite a greater proportion of Hispanics living in poverty, lacking health insurance, and having limited access to health care, but he indicates that there is some controversy over those studies. *Id.* Some studies suggest that mortality rates for Hispanic women are significantly lower than rates of Caucasian women at all ages; while mortality rates for Hispanic men tend to be slightly higher than for Caucasian men at most ages. *Id.* There is also substantial heterogeneity within the Hispanic population. *Id.* at 5. Foreign-born persons tend to have a lower mortality risk than United States born persons. *Id.* at 5-6; *see also* JEFFREY R. BROWN, REDISTRIBUTION AND INSURANCE: MANDATORY ANNUITIZATION WITH MORTALITY HETEROGENEITY (Nat'l Bureau of Econ. Research, Working Paper No. 9256, 2001) [hereinafter BROWN No. 9256] (discussing the distributional implications of mandatory annuitization). Professor Brown used data from the National Longitudinal Mortality Study (NLMS), a survey of individuals who were originally included in the Current Population Survey (CPS) and/or the Census in the late 1970s and early 1980s to construct cohort mortality tables for specific racial and ethnic groups. *Id.* at 7-8. The tables indicate how the life expectancy of a 22-year old in the year 2000 varies by gender, race, ethnicity, and education. *Id.* at 10. The average 22 year-old male can expect to live to age 77.4, while the average 22-year old female can expect to live to age 83.4. *Id.* Caucasian, African American, and Hispanic 22-year old males can expect to live to age 78.1, 71.4, and 77.5 respectively; while the comparable life expectancies for 22-year old females are 83.8, 79.7 and 85.6 respectively. *Id.* A 22-year old Caucasian male with a college education can expect to live to age 80.5, compared to age 77.8 for one with at least a high school education and 75.3 for one without a high school education. *Id.* The comparable numbers for African American males are 75.7 years, 71.6 years, and 68.1 years respectively. *Id.* Life expectancies at age 67 for the same cohort also varied but the difference in years was not as large as at age 22. *Id.* For example, a 67-year old Caucasian male can expect to live 16 months longer than a 67-year old African American, and a college educated Caucasian male can expect to live 3.4 years longer than a African American male with less than a high school education. *Id.* It is not clear whether these differences would also be present in the self-selected population of annuity purchasers in the various groups.

106. BROWN No. 9256, *supra* note 105, at 6. Three measures of status are used in the literature: education, income and wealth. *Id.* at 5. A significant negative correlation between education and mortality is nearly always found, but education could merely be a proxy for income rather than an independent factor. *Id.* at 7. There is a significant negative correlation between current income and mortality, but it is unclear whether this is a cause or effect; individuals in poor health may simply be unable to earn high incomes. *Id.* at 6. Finally, there is compelling evidence that wealth and mortality are also negatively correlated. *Id.* Again, it isn't clear to what extent low wealth accumulation is the cause of increased mortality as opposed to increased rates of mortality being the cause of low wealth accumulation. *Id.*

more conservative in their annuity mortality assumptions used in setting premium rates.[107]

While nonqualified annuity payouts do vary with the sex of the annuitant, insurance companies do not take the other factors just discussed into account. The problem of determining whether those factors predictably affect annuitant longevity may be the principal reason most insurers do not attempt to underwrite annuity policies to the same extent they underwrite life insurance, but the increasingly competitive nature of the annuity market may eventually lead some companies to attempt to gain market share by offering such differentiated products.[108]

To take adverse selection into account, the mortality tables used by insurance companies to price their annuities are based on very conservative mortality rates.[109] The annuity mortality tables that have been developed to price immediate annuities are not even based on the mortality experience of persons who voluntarily purchase annuities. Because the voluntary annuity market is so thin, it has not been possible to obtain good data with respect to the mortality of voluntary purchasers. Most of the data used to construct the annuity mortality tables concerns mortality in the retirement annuity market, where in many cases annuitization is required rather than voluntary, lessening any adverse selection effects. The individual annuity tables

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107. If medical science permits more objective individualized assessments of mortality risk, this may permit insurers to become more willing to underwrite annuity risks and offer varying premium rates to various risk groups. However, that is probably a long way off since companies will want solid evidence based on long-term studies before they will be willing to underwrite annuity risks in that manner.

108. There are potential regulatory hurdles to such underwriting. For example, state insurance regulators probably prohibit racially discriminatory rates.

109. Mortality risk is quantified by using a mortality table, which has been constructed to provide a mathematical method to compute the probability that a person of a given age will survive to another age. BLACK & SKIPPER, *supra* note 33, at 696-97. A mortality table is usually based on mortality observed in a population in the past. *Id.* It shows a hypothetical group of individuals beginning with a certain age and traces the mortality history of that group year by year until all have died, and it permits the computation of the probability that a person of a given age will survive to any later age—the mortality premium factor used in pricing annuities. *Id.* The construction of a mortality table is a complicated process, and there are several different types of mortality tables used for different purposes. *Id.* at 696-709. Recently, the Society of Actuaries endorsed the Annuity 2000 Basic Mortality table, which was projected from the 1983 table, as suitable for the valuation of individual annuity business. *Id.* at 707.

No mortality table can accurately predict the probability of survival of any given individual in an insured population. *Id.* at 702. There is a mathematical concept called the law of large numbers that permits an insurer to rely on the probabilities predicted by an accurate mortality table in setting the premiums it charges on its policies. *Id.* at 695. The law of large numbers, as applied to insurance, states that the greater the number of insured persons, the less the actual mortality experience in the insured population will deviate from the predicted mortality. *Id.* Uncertainty and risk of deviation diminish as the insured population increases in size. *Id.* at 26-27, 694-96. Insurers may also transfer all or part of a risk to another insurance company through reinsurance. *Id.* at 683. The primary purpose of reinsurance is to avoid too large a risk concentration within one company. *Id.* at 683-91.

constructed from this data were deliberately made more conservative to take into account the voluntary nature of the individual annuity market and the probability of adverse selection by purchasers. Some companies use these annuity tables to price their products on the assumption that the tables reflect more conservative mortality assumptions than the actual past mortality experience of their own annuity policyholders. These mortality tables are clearly not actuarially fair to someone with only an average life expectancy, and because any mortality data on voluntary purchasers of annuities compiled by individual companies is not available to the public, there is no easy way to verify whether the tables used to price them even reflect a reasonably accurate estimate of the life expectancy of the self-selected group of actual annuity purchasers.[110]

Mortality guarantees on deferred annuities are even more conservative since they are determined when the contract is purchased, which may be decades before annuity payments actually begin. The company must make a rational determination of what mortality rates are likely to be at the time in the future when annuity payments are to begin to properly price its guaranteed annuitization rates. There is no guarantee that those rates, even if they can be accurately determined today, will be constant in the future. In fact, it would be remarkable if they were, given past experience.[111]

Whether we can reasonably expect to see a continuation of past declines in mortality and if how we can accurately predict the future mortality trends is subject to considerable debate.[112] Insurance companies

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110. Armand M. DePalo et. al., Remarks at the 2000 Valuation Actuary Symposium, 10PD, Updating Valuation Mortality Standard (Sept. 14-15, 2000). Esther H. Milnes stated that there is very little data on payout annuities that are subject to self-selection and that there was a need to gather that data for the benefit of both the insurance companies and the public. *Id.* at 29. The companies that are relying on the past mortality experience of their own policyholders are taking a risk that new customers will have better mortality experience than past customers, better than the mortality tables predict.

111. Robert B. Friedland, *Life expectancy and the Future: A Summary of a Discussion Among Experts*, 2 N. AM. ACTUARIAL J. 48, 49 (1997). Mortality rates have consistently declined in the past century. *Id.* For example, "For most of the time humans have existed, life expectancy at birth was about 18 years." *Id.* "Throughout the Middle Ages, life expectancy at birth was less than 25 years, and before the 1700s, it was less than 40 years." *Id.* Now, life expectancy at birth exceeds seventy-five years in North America and is about eighty-two years in Japan. *Id.* "Prior to the twentieth century, survival to a very old age meant living 50 or 60 years; at the end of the twentieth century, it meant living beyond age 95." *Id.*

112. In October 1997, the Society of Actuaries organized a daylong seminar to bring together experts on mortality rates from different disciplines to examine factors affecting mortality change and mortality assumptions throughout North America and to provide advice about forecasting mortality rates in the future. Robert B. Friedland, PhD., the Director of the National Academy on an Aging Society in Washington, D.C. published a paper summarizing the seminar. Friedland, *supra* note 111. Two major background documents cited in the summary were also published in the same volume. *See* Shripad Tuljapurkar & Carl Boe, *Mortality Changes and Forecasting: How Much and How Little Do We* Know?, 2 N. AM. ACTUARIAL J. 13 (1997); Shripad Tuljapurkar,

tend to err on the side of prudence. To take into account possible future increases in life expectancy, an insurance company will use a mortality table that projects lower expected future mortality rates.[113] Projecting essentially means estimating, and often estimates are little more than educated guesses.[114] All commercial deferred annuities provide extremely conservative mortality guarantees.[115] A recent study has concluded that the

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Forecasting Mortality Change: Questions and Assumptions, 2 N. AM. ACTUARIAL J. 127 (1997). A recent book discusses the possible effects of the human genome project on future life expectancy. NICOLAS WADE, HOW THE HUMAN GENOME DISCOVERIES WILL TRANSFORM MEDICINE AND ENHANCE YOUR HEALTH (Simon & Schuster 2001).

A critical question is whether improvements in life expectancy are merely bringing us closer to the edge of the human life span or whether the life span is also increasing. Friedland, *supra* note 111, at 52. If there is a limit to human longevity, as life expectancy approaches that limit, the rate of decline in mortality rates will eventually slow down. *Id.* If there is no upper limit to human longevity, the rate of decline in mortality rates could accelerate indefinitely. *Id.*

113. BLACK & SKIPPER, *supra* note 33, at 704-05. Such a mortality table is called a table with projections. *Id.*

114. As a pricing actuary with considerable experience aptly stated:

> There is no underlying physical law that mortality follows (or at least we don't know what it is yet) that would allow us to predict with scientific accuracy future trends in mortality. We subconsciously recognize that we don't have this ability when we use words like "assumption" and "projection" to describe what it is we're doing. There are other words that could be used to describe this process, and these words better emphasize the unreliability of what we do when we make mortality assumptions. . . . These words were suggested to me by the Microsoft Word Thesaurus, my primary source for alternative words: "forecast," "prediction," "supposition," "conjecture," "opinion," "hypothesis," "belief," "guess," and "shot in the dark."

Ronald L. Klein et al., Session 83D Pricing With Mortality Improvements, Discussion Before the Montreal Spring Meeting of the Society of Actuaries (June 19-20, 1997), *in* 23 RECORD No.2, at 6. Companies generally act conservatively, which means that they do assume mortality improvements in pricing their annuity products but not in pricing their life insurance products. *Id.* at 19.

115. An insurer selling a deferred variable annuity normally separately charges for any guarantees it makes (referred to as "unbundling"), and these are normally collected in the form of fees charged against the investment funds in the subaccounts backing the contract. The annual charge for the mortality guarantee is about one half of one percent. Robert J. Johansen, *Review of Adequacy of 1983 Individual Annuity Mortality Table*, 47 TRANSACTIONS OF SOC'Y OF ACTUARIES 211, 223 (1995). As a matter of deferred variable annuity design, there are a number of possibilities with respect to mortality guarantees. At one extreme, it is theoretically possible for the insurer to make no mortality guarantees, other than to guarantee that the policyholder will be able to purchase an annuity with the accumulated value at whatever rates the insurer is using at that time. Since this guarantee would present no risk to the insurer, it could provide this guarantee with no charge. CREF currently adopts this alternative for its qualified retirement annuities. In fact, those annuitants are given no mortality guarantees even after annuity payments begin. This is a pure variable annuity, under which the annuitants bear both the investment and mortality risks, and future payments will vary if investment and mortality results vary. No nonqualified annuity similarly lacks any mortality guarantees. It may be that such a nonqualified annuity would not qualify for current income tax favored treatment if it were offered because such an annuity must be one that is considered to be an annuity contract "in accordance with the customary practice of life insurance companies." *See supra* Part II, Section A. The IRS has ruled that an annuity must provide permanent purchase rate guarantees. Rev. Rul. 77-286, 1977-2 CB 228. Legislative history also indicates that some form of annuity guarantees are required. *See* GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 ("Blue Book" prepared by the Staff of the Joint Committee on Taxation) at 584; *see also* John H. Biggs,

mortality guarantees under a typical deferred variable annuity are so conservative that they are of very little value.[116]

3. *Other Cost Factors*

The adverse selection issue is not the only pricing factor that may deter the purchase of an annuity. Since the computation of annuity payments is mathematically precise, one might conclude that it should not matter, aside from considerations of financial stability of the company, from which

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Alternatives in Variable Annuity Design, 21 TRANSACTIONS OF SOC'Y OF ACTUARIES, 61, 495-517 (1969) (discussing variable annuity design).

116. Moshe Milevsky & Steven E. Posner, *The Titanic Option: Valuation of the Guaranteed Minimum Death Benefit in Variable Annuities and Mutual Funds*, 68 J. OF RISK AND INS. 91, 97 (2001) (stating that the mortality guarantee "has little value-and is not a significant component of the M&E charge-since it is ignored by pricing actuaries, valuation actuaries, regulators, and the reinsurer." The study concludes that the charge made for the typical return of premium minimum death benefit is overpriced by five to ten times its value. Nancy M. Kenneally et al., Session 11PD Variable Products-Pricing Issues, Panel Discussion Before the Washington Annual Meeting of the Society of Actuaries Washington Annual Meeting, (Oct. 26-29, 1997), *in* 23 RECORD No.3, at 6. Mr. Ruark, a fellow of the Society of Actuaries employed by CIGNA Corp., stated that when a policyholder annuitizes at the guaranteed rate, the company has "the potential to gain from annuitization. Of course, anyone who has spent some time with purchase rates, immediate annuities, guaranteed purchase rates, and VA [variable annuity] knows they tend to be conservative." *Id.*

At a session of the spring 1999 meeting of the Society of Actuaries concerning the actuarial assessment of the risks of guarantees on variable products, it was emphasized that the guaranteed rates on deferred annuities are very rarely "in the money," running about 70-75 percent of current rates, which are themselves extremely conservative most of the time. Nancy M. Kenneally et al., Session 90PD Guarantees on Variable Products: How Are Companies Assessing the Risks?, Panel Discussion Before the Atlanta Spring Meeting of the Society of Actuaries (May 24-25, 1999), *in* 25 RECORD No. 1, at 14 (statement by Mr. Sakoulas). At the 1999 Valuation Actuary Symposium, it was bluntly stated that the guaranteed mortality rates on deferred variable annuities are so conservative that it is assumed they are never going to be actually used. James W. Lamson & Timothy E. Hill, Remarks at the 1999 Valuation Actuary Symposium, Session 25, Minimum Guaranteed Benefits for Variable Annuities: Implementing Guidelines, at 21. A paper submitted to the Actuarial Society concluded that the cumulative charges made for the mortality guarantees on a typical policy based on the 1983 annuity table were sufficient to protect the companies from any loss due to annuitization at those rates, which the report concluded were too generous as of 1996, due to mortality improvements. Johansen, *supra* note 115, at 221, 223. The study assumed a contract was issued in 1983 and was in the accumulation phase until the owner reached age sixty-five in 1986 and annuitized it. *Id.* It concluded that even if the annuitant exhibited the improved mortality found in the study, the company would not have a loss under any reasonable assumption as to investment returns over the accumulation period. *Id.* at 223. Since many policyholders will not annuitize, the companies will likely realize significant profits from these fees. *Id.*

These conservatively computed mortality rates are only the guaranteed rates, and if mortality experience does not continuously improve or improves at a slower rate than assumed in the mortality table used to compute the guarantees, then at the time the policyholder begins to receive annuity payments under the contract, the company's current mortality guarantees for guaranteed immediate annuities purchased at that time will be more favorable. Typically, a deferred annuity contract will guarantee that if this occurs, the policyholder will be provided the higher benefit. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 1:14. If the contract did not have such a provision, the policyholder could merely exchange the old annuity policy for a new annuity policy with the more favorable rates without recognition of gain. *See supra* note 59 and accompanying text.

company a policy is purchased. However, expenses and profit margins can vary greatly from company to company. A recent study concerning the money's worth of commercial annuities found that monthly annuity payments varied substantially. For example, in 1995, a 65-year old male might receive from $725 to $872 monthly depending on the company.[117]

4. *Optimal Planning of Timing of Annuitization*

Since there is risk of loss due to premature death after annuitization, optimal financial planning is to delay annuitization as long as reasonably possible since waiting can provide additional valuable information about one's survival probabilities. The additional information gained by delay is particularly important in the commercial annuity market because individuals who do not have well above average life expectancies are financially penalized by the conservative annuity mortality tables used to price commercial annuities.

A recent article concluded that given the high costs of annuities, a 65-year old female (male) has a 90 percent (85 percent) chance of beating the rate of return from a life annuity until age 80.[118] The study is based on a "do-it-yourself" scheme: a person makes systematic withdrawals from one's accumulated funds of the age 65 annuity payment amount each year from age 65 until age 80 and then uses the remaining funds to purchase a life annuity at age 80.[119] Actual annuity rates offered by Canadian companies were used in making the calculations.[120]

Another analysis based on United States annuity mortality rates concludes that by delaying the start of an annuity from age 65 to age 70, a person at age 70 would be able to fund up to 95 percent of the annuity income that he or she would have had if the annuity had been started at age 65 and up to 85 percent by delaying to age 75.[121]

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117. Mitchell, et al., *supra* note 84, at 1305-17. The authors could find no correlation between risk and the price of commercial annuities. *Id.* at 1300. Insurers with higher financial ratings did not in general charge substantially higher prices. *Id.*

118. Moshe Arye Milevsky, *Optimal Asset Allocation Towards the End of the Life Cycle: To Annuitize or Not to Annuitize?* 65 J. OF RISK AND INS. 401, 418 (1998).

119. *Id.* at 414.

120. *Id.* at 410.

121. John Ameriks, *The Retirement Patterns and Annuitization Decisions of a Cohort of TIAA-CREF Participants*, 60 RES. DIALOGUES (TIAA-CREF Inst., New York, N.Y.), Aug. 1999, at 10-12. The computations are based on a do-it-yourself scheme similar to the one described in the text describing the Canadian study: a person makes systematic withdrawals from one's accumulated funds of the age 65 annuity payment amount each year from age 65 to age 70 or 75 and uses the remaining funds to purchase a life annuity at age 70 or 75. *Id.* These calculations are not based on actual annuity rates offered by insurance companies but rather only on annuity rates under certain mortality and interest rate assumptions. *Id.* Since the assumed annuity rates do not

Based on the results of these studies, optimal financial planning is to delay annuitization for some considerable period after the normal retirement age of 65. In general, the cost of delay increases as an individual ages because the benefits of delay decrease with age; as one ages, the likely length of one's future and therefore any uncertainty about it inevitably decreases. The cost of delaying at least 5 years is not that significant and would probably be attractive to most individuals. While the cost of delaying 10 years is more than twice as great, it may well be acceptable to a risk-averse individual.

5. *Other Non-Pricing Factors*

The pricing issue alone does not explain the almost complete lack of annuity demand in the United States.[122] However, several other factors in combination may lessen or even eliminate the economic value of annuities, and these factors will affect the decision by owners of deferred variable annuities whether or not to annuitize.

To the extent that lack of inflation protection on most commercial annuities is a factor that inhibits annuitization,[123] variable annuities do provide some measure of inflation protection since the payments vary with the investment results of the underlying investment fund or funds that back

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include other annuity expense charges, it is likely that the costs of waiting to annuitize are somewhat overstated and are in fact closer to those found in the Canadian study.

122. BROWN & WARSHAWSKY, *supra* note 19, at 7-8. Evidence of low annuitization rates in the Federal Thrift Savings Plan, which provides more attractive annuitization rates than does the commercial annuity market, also supports this conclusion. *See* JAMES M. POTERBA & MARK J. WARSHAWSKY, THE COSTS OF ANNUITIZING RETIREMENT PAYOUTS FROM INDIVIDUAL ACCOUNTS, (Nat'l Bureau of Econ. Research, Working Paper No. 6918, 1999). The Federal Thrift Savings Plan (TSP) is a relatively new supplemental defined contribution plan for federal government employees. That plan is a 401(k) defined contribution plan for federal employees established in 1986. Upon leaving government service, an employee may withdraw assets in three ways: a life annuity, a lump sum, or a series of monthly payments. Annuities are purchased from a commercial annuity seller after a competitive bidding process. The process is handled through a request for proposal (RFP) inviting bids. The RFP details the mortality assumptions and interest rate assumptions that must be used in pricing the annuity. *Id.* at 14-17. The annuitization rates resulting from the process were more favorable than rates generally available to the public. *Id.* at 18-19. Approximately 1.2 percent of the eligible participants were choosing to annuitize. *Id.* at 26 (citing information received from Metropolitan Life Insurance Co.).

123. JEFFREY R. BROWN ET AL., THE ROLE OF REAL ANNUITIES AND INDEXED BONDS IN AN INDIVIDUAL ACCOUNTS RETIREMENT SYSTEM, (Nat'l Bureau of Econ. Research, Working Paper No. 7005, 1999) at 10. While the Social Security system provides annuities that are indexed to the consumer price index, nearly all commercial annuities available in the United States are fixed or nominal annuities. *Id.* However, this alone cannot explain the lack of demand for annuities. In an inflation-linked annuity, the company guarantees that annuity payments will increase each year based on inflation measured by some external index. Irish Life, PLC, an international insurance firm headquartered in Dublin, Ireland, offers index-linked annuities in the United States through Interstate Insurance Company, a division of Irish Life of North America (ILONA). *Id.* As of 1999, there were no United States sales of the product. *Id.*

the contract. While there is no necessary correlation between inflation and the returns on any investment fund, and while empirical results indicate that the inflation hedging properties of both equities and long-term bonds are limited,[124] over the long term, a diversified equity fund has a good probability of providing returns that outpace inflation, at the price of volatility. One economic study concluded that an investor with a reasonable level of risk aversion would prefer an equity backed variable annuity to a completely inflation protected non-variable annuity.[125] Since deferred variable annuities do provide the option of choosing a variable annuity payout, they may be more likely to be annuitized than deferred fixed annuities.

However, the remaining factors that contribute to resistance to annuitization in general will likely also contribute to resistance to annuitizing deferred variable annuities. These factors include (1) the irreversibility of annuitizing with the attendant lack of ability to access the assets used to purchase the annuity if the annuitant's financial circumstances change;[126]

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124. *Id.* at 19-24. The study concludes that there is a negative correlation between equity or bond returns and unexpected inflation. *Id.* at 24.

125. *Id.* at 35-36. The variable annuity is even more attractive to investors who already have a substantial portion of their net worth invested in an inflation-adjusted annuity, such as Social Security. *Id.* at 37-38.

126. BROWN & WARSHAWSKY, *supra* note 19, at 12. The most significant problems faced by some retirees are the possibility of incurring large uninsured medical expenses and long-term care expenses. *Id.* Medicare, together with Medigap policies and in some cases retiree health benefits, adequately insures a very large portion of the medical expenses of most elderly persons. *Id.* Even retired persons covered by Medicare are not adequately covered for long-term care. Medicare covers only 100 days of long-term care and only in certain limited circumstances. *Id.* Medicaid imposes strict income and asset eligibility tests that generally require that individuals exhaust substantially all of their personal assets and apply all but a minor amount of their income to cover nursing home costs. *Id.* Among those aged 65 and over, 60 percent will need some long-term care in their lifetime. *Id.* at 13. While the escalating cost of long-term care services is a substantial financial risk to individuals, very few are insured against it. *Id.* at 14. Less than 8 percent of the elderly own such a policy, and group employer sponsored coverage is rare. *Id.* Individuals may be reluctant to annuitize because they wish to retain financial assets to pay such expenses. *Id.*

One reason many retirees do not purchase long-term care insurance is that, due to adverse selection with respect to that product, the cost of coverage is quite high. Christopher M, Murtaugh et al., *In Sickness and in Health: An Annuity Approach to Financing Long-Term Care and Retirement Income*, 68 J. OF RISK AND INS. 225, 228-29 (2001). Recently it has been suggested that combining a long-term care policy with an immediate annuity would substantially reduce the cost of both contracts by reducing adverse selection. *Id.* at 229. The specific form proposed is a fixed immediate annuity with payments that increase upon the determination of a chronic disability. *Id.* Such a combination policy would greatly reduce, without costly underwriting, the adverse selection problem with respect to both the annuity and the long-term care aspects of the policy. *Id.* at 229-30. The policy pools two opposing risks—long life versus short life with disability. *Id.* at 231. The product could be priced more cheaply than separately purchased products and thus be attractive to more people. *Id.* at 227. Such creative payout methods can address the reluctance to annuitize to the extent it is based on legitimate liquidity concerns.

(2) the presence of other sources of annuity income;[127] (3) bequest motives[128]and risk sharing in families;[129] and (4) lack of understanding of annuities.[130]

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127. BROWN & WARSHAWSKY, *supra* note 19, at 6. Economists agree that the value of annuitization decreases at the margin. *Id.* In other words, if people already have a reasonable level of available annuity income, the value of additional annuitization decreases. *Id.* The more sources of annuity income they have, the less likely they are to voluntarily annuitize their remaining wealth. *Id.* Since most individuals are eligible for Social Security, which provides an inflation-adjusted rather than a nominal annuity, the value of any additional voluntary annuitization is lessened. *Id.* at 10. The study concludes the value of additional annuitization is still substantial. *Id.* at 6. Thus, the existence of preexisting annuity wealth cannot by itself explain the extreme aversion of individuals to voluntarily annuitize their assets. *Id.*

A large percentage of non-retired owners of nonqualified annuities said that money they put into a retirement plan at work (48 percent) or money their employer put into a retirement plan (43 percent) would be a major source of their retirement income. GALLUP SURVEY, *supra* note 92, at 28. The survey did not provide separate responses for fixed and variable annuity owners. *Id.* The survey also disclosed that 75 percent of non-retired variable annuity owners had individual retirement accounts (IRAs). *Id.* at 21.

128. *See* BROWN & WARSHAWSKY, *supra* note 19, at 8 (citing the literature on the subject). Wealth an individual intends to bequeath is no longer optimal to be used to purchase a life annuity; a pure life annuity ends at the death of the annuitant and nothing will pass to any beneficiaries. *Id.* Unfortunately, there is little consensus on whether bequest motives have an important effect on consumption decisions. *Id.* at 8-10.

129. *Id.* at 9-10. Married couples may engage in risk sharing between them. *Id.* at 9. Two individuals sharing a common budget can obtain significant utility gains through this type of self-insurance. *Id.* at 9-10 (citing studies quantifying the utility gains obtained as a result of risk sharing between two individuals who share a common budget). A large percentage of purchasers of deferred variable annuities are married individuals who therefore are less likely to value annuitization. GALLUP SURVEY, *supra* note 92, at 6. According to the 2001 Gallup survey, 63 percent of nonqualified annuity owners were married. *Id.* at 7.

130. BROWN & WARSHAWSKY, *supra* note 19, at 14-16. There is evidence that consumers have very little knowledge about annuities or understanding of how they work. *Id.* at 14 (citing a Task Force report by the American Council of Life Insurance). The least understood aspect of annuities is how risk shifting allows insurers to offer life annuities. *Id.* at 15. Consumers tend to focus on the risk of dying early rather than the risk of outliving their assets. *Id.* Some consumer focus group participants viewed lifetime annuity payments as gambling on their lives and believed the odds favored the insurance company. *Id.* They viewed annuities as a source of risk rather than as insurance against risk. *Id.*

Income options available for annuity payouts may also be a source of difficulty, including whether to purchase a fixed or variable annuity, whether to purchase a single life annuity or a joint annuity with a spouse or other person, and whether to purchase a pure life annuity or one with a refund feature such as a ten year guarantee. All of these choices require some knowledge of likely future rates of inflation and the likely life expectancy of both oneself and one's spouse. In short, choosing how to annuitize requires complex predictions about an inherently unpredictable future. George Loewenstein, *Is More Choice Always Better?*, SOCIAL SECURITY BRIEF No. 7 at 6 (National Academy of Social Insurance October 1999). *Id.* The Brief is a very good discussion of issues that must be addressed if the Social Security system is amended to permit individual accounts. The principles discussed are equally applicable to any system that permits choice as to whether to purchase an annuity. *Id.*

To the extent these difficulties are due to lack of basic knowledge or lack of understanding of annuities, focused educational efforts may be effective in increasing willingness to annuitize. There is currently very little such education provided by insurance companies to purchasers of deferred variable annuities.

6. *Psychological Factors*

Psychological factors may also play a role in reluctance to annuitize. Many people can be shortsighted when weighing short-term sacrifices against long-term benefits or gains. They might tend to focus more on the chance of premature death than on the possibility of longevity. When buying an annuity, the sacrifices—giving up control of one's assets and the possibility of loss due to premature death—are proximate; while the primary gains—protection against longevity—are remote and speculative.[131]

Even though the potential gains equal the potential losses if the annuity price is actuarially fair to the purchaser, losses have a much larger psychological effect on individuals than do gains; people experience much more pain from a loss than they experience pleasure from an equal amount of gain.[132] So even if the two are equal, the loss is more immediate and the prospect of the loss may psychologically far outweigh the possibility of gain. Even worse, because of adverse selection in commercial annuities, the potential gains do not even equal the potential losses for a person with average life expectancy.

In theory, loss aversion should not be a factor in the purchase of an actuarially fair annuity by one with no bequest motives or need for precautionary savings. Since the cost of an annuity is the fact that future payments are cancelled at death, to an individual who is only concerned with smoothing lifetime consumption and has no need for accumulated assets, there is no cost to the annuity.[133] Thus, the individual should always choose the annuity because it offers a greater return due to the mortality premium.

There is clear evidence that loss aversion of some kind is involved in the annuitization decision. Those who do annuitize overwhelmingly choose an option with a guaranteed period, very non-optimal behavior from an

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131. Loewenstein, *supra* note 130, at 5. The mortality premium included in each annuity payment is a more immediate benefit, but it is a relatively small part of each payment, particularly the earlier payments in the annuity stream.

There is evidence that individuals have a tendency to favor a lump sum over a series of payments, even if the two are actuarially equivalent, which is sometimes referred to as "wealth illusion." David Fetherstonhaugh & Lee Ross, *Framing Effects and Income Flow Preferences in Decisions about Social Security*, *in* BEHAVIORAL DIMENSIONS OF RETIREMENT ECONOMICS, *supra* note 2, at 194-96. Wealth illusion may "bias intuitive beliefs about the mathematics of annuities in a direction that favors the lump payment." *Id.* at 213 (comment by Daniel Kahneman).

132. *See infra* Part IV (discussing loss aversion).

133. JEFFREY R. BROWN, PRIVATE PENSIONS, MORTALITY RISK, AND THE DECISION TO ANNUITIZE, (Nat'l Bureau of Econ. Research, Working Paper No. 7191, 1999) at 6. Even a person with a bequest motive would presumably invest the wealth he or she wishes to bequeath outside of the annuity and purchase an annuity with the remainder. *Id.*

economic standpoint.[134] This behavior indicates that an individual may not analyze the decision whether to purchase an annuity in purely economic terms.

If people learn shortly after the purchase that their life span is likely to be shorter than anticipated, they are likely to experience serious regret;[135] while if they decide not to purchase an annuity and outlives their assets, they will also experience serious regret as well as serious financial hardship.[136] For these reasons, just focusing on the decision whether or not to purchase an annuity is psychologically difficult and may be avoided by some people for that reason alone. The decision is even more complicated when other factors are considered, such as whether to purchase inflation protection or whether to purchase a joint annuity to protect a spouse. Such decisions require making even more predictions about an uncertain and unpredictable future, further increasing the psychological costs.[137] In the case of a variable annuity with a large number of investment choices, the annuitization decision is further complicated by having to choose which of the subaccounts to annuitize in, if a variable pay out is chosen.

Studies based on annuitization decisions by participants in the TIAA-CREF retirement system, one of the largest retirement systems in the world, indicate that the number of alternative options available may accentuate the psychological resistance to voluntary annuitization.

Prior to 1988, all TIAA-CREF basic pension plans allowed for distributions only through life annuities or death benefits, but since then, a number of other distribution methods have become available.[138] The annuity rates offered by the TIAA-CREF annuities are generally higher than those commercially available.[139] Nearly 60 percent of individuals age 65 and

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134. *See* Jeffrey R. Brown, *Redistribution and Insurance: Mandatory Annuitization With Mortality Heterogeneity*, CRP WP 2001-02 (Center for Retirement Research at Boston College, Chestnut Hill, MA) April 2001, at 27 (citing research showing that annuities with "period certain" options—life with ten years certain—are extremely popular in the United States). In the TIAA-CREF retirement system, a large majority of purchasers of two-life annuities choose twenty-year guarantees while a majority of purchasers of one-life annuities choose either no guarantee or a ten-year guarantee, with more women than men choosing no guarantee. Francis P. King, *Trends in the Selection of TIAA-CREF Life-Annuity Income Options, 1978-1994*, 48 RES. DIALOGUES 1 (TIAA-CREF Inst., New York, N.Y.), July 1996, at 4-5.

Professor Brown shows that the optimal economic solution for one who desires to make a bequest is to keep the wealth to be bequeathed in non-annuitized form and annuitize the rest. Brown, *Redistribution and Insurance*, *supra* at 29.

135. Loewenstein, *supra* note 130, at 5-6. Professor Brown refers to this as "a form of ex *ante* regret." Brown, *supra* note 134, at 29.

136. Lowenstein, *supra* note 130, at 6.

137. *Id.*

138. *See* Ameriks, *supra* note 121, at 4. The report examined a cohort of participants over a period of time. *Id.*

139. POTERBA & WARSHAWSKY, *supra* note 122, at 25.

over retiring from 1994 through 1996 started their first life annuity within one year of retiring, but the frequency of that choice has declined steadily as the number of alternative options available to participants has expanded.[140] Since the owner of a deferred variable annuity can choose any method of payout, including cashing the policy in for a lump sum, and may delay any payout until a very advanced age, there is little reason to conclude that the current very low rate of annuitization will increase.

Experience with the TIAA-CREF retirement system also indicates that another factor contributing to reluctance to annuitize may be increasing wealth. Individuals who find themselves wealthier than they expected have less fear of outliving their assets, and they may feel that annuitization is too costly in terms of preventing the use of their wealth for other purposes, such as emergencies or bequests.[141] A very large percentage of variable annuity owners also own other financial assets.[142] Since they are likely more wealthy than average, voluntary annuitization by them is less likely.

If reluctance to annuitize is due to lack of understanding of annuities, then educational efforts might be effective to increase annutization rates. Employers in the TIAA-CREF system and the federal government provide educational programs to their employees to explain the savings program and the payout options. However, there is less opportunity to provide organized educational programs to variable annuity owners, and there is no evidence that insurance companies or sellers of deferred variable annuities are making any significant efforts to educate policyholders about the benefits of annuitization. In fact, as discussed in the next part of this article, there is almost complete lack of any emphasis on the annuity aspects of deferred annuities by the sellers of the product.

Insurance company actuaries are aware of the psychological barriers to annuitization, and they take it into account in estimating reserve funding requirements for certain guaranteed benefits on deferred annuities. Instead

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140. Ameriks, *supra* note 121, at 5-7. The data shows a decline in annuitization rates at all ages, but the decline is slightly larger for older individuals. *Id.* For men aged 70, the rate fell form 83.4 percent in 1987-90 to 57 percent in 1994-96; while at age 62, the decline was from 66.3 percent to 52.1 percent. *Id.* The drop was greatest from the 1991-93 period to the 1994-96 period. *Id.* at 5.

141. Ameriks, *supra* note 121, at 10. In general, the decline in annuitization rates was slightly larger among individuals with greater equity allocations. *Id.* It is also possible that increased equity allocations indicate a greater likelihood to take risks, so that they are less worried about longevity risks and more willing to take financial risks in self-managing their assets rather than annuitizing. *Id.*

142. GALLUP SURVEY, *supra* note 92, at 21. According to the 2001 Gallup survey, large percentages of variable annuity owners also owned mutual funds (eighty percent), individual retirement accounts (seventy-five percent), and individual stocks or bonds (sixty-eight percent). *Id.* The survey does not inquire into wealth levels.

of providing educational programs to address the fact that policyholders may not act in their best economic interests in deciding whether to annuitize, insurance companies are in part relying on the strong aversion to annuitization to protect themselves from any losses on annuity guarantees that require annuitization.[143] One actuary stated, "As we all know, annuitization is still probably the longest four-letter word that we see out there in the annuity business today."[144]

One additional source of evidence concerning the likelihood that owners of deferred annuities will voluntarily annuitize is the current legislative proposal supported by the insurance industry to provide significant additional tax benefits to policyholders who choose a life contingent payout—the Lifetime Annuity Payout Act.[145] Under that proposal, the income element in a lifetime annuity payment would be taxed at capital gain rates, rather than at ordinary income rates as it is under current law. The provision would apply to both immediate nonqualified annuities and annuitization of a deferred nonqualified annuity. If a significant number of owners of deferred variable annuities are likely to voluntarily annuitize without the additional tax benefit, then providing additional expensive tax incentives for doing so is unnecessary and difficult to justify when other needed government programs are being cut due to expected federal deficits. The proposal seems to be a tacit admission by the industry that the level of voluntary annuitization of deferred annuity contracts will not be significant.

7. *Incentives of Insurance Companies and Financial Planners Concerning Annuitization of Deferred Variable Annuities*

While insurance companies have incentives to induce individuals to purchase immediate or deferred annuities, they do not have a strong economic incentive to encourage owners of deferred annuities to begin to receive payments. The purchase of an immediate or deferred annuity means new money coming into the company, but the conversion of an accumulating deferred annuity into payout phase means money going out of

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143. *See, e.g.*, Lamson & Hill, *supra* note 116, at 23; Kenneally, Session 90 PD, note 116, at 14. Both sessions concerned assessing the risks of various annuity guarantees. At both sessions, it was noted that even when a guarantee was "in the money," the policyholder still might not do so because of psychological resistance. John M. O'Sullivan et al., Remarks at the 2000 Valuation Actuary Symposium, Session 17PD, Minimum Guaranteed Death Benefits on Variable Annuities, at 5.

144. O'Sullivan, *supra* note 143, at 5.

145. In November 2001, Representatives Phil English (R-PA), Nancy Johnson (R-CT), and Karen Thurman (D-FL) introduced the Lifetime Annuity Payout Act, H.R. 3320, into the House of Representatives. H.R. 3320 107th Cong. (2001). Since then, other members have joined as co-sponsors. *Id.* The legislation would only apply to nonqualified annuities, not those purchased with funds in qualified plans. *Id.*

the company. While agents receive additional compensation for selling new policies, they do not generally receive additional compensation if one of the policies they previously sold is annuitized.[146] Annuitization also creates risk for the company: if the mortality assumptions used in pricing the annuity payouts are not accurate, the company could suffer a loss on annuitized policies. Non-annuitized policies do not present that risk. In addition, if the guaranteed mortality rates on payouts for a group of policies should turn out to be favorable to the policyholders, the company will have no incentive to encourage their annuitization.[147] Some companies are now moving toward changing the compensation scheme to provide incentives to agents to encourage policyholders to annuitize a policy rather than surrender it for cash or exchange it for another company's annuity, but there is still little incentive for agents or companies to encourage annuitization of a policy that would otherwise remain in the accumulation phase.[148] Likewise, financial planners may have little incentive to recommend annuitization to their clients. Simply stated, how likely is it that a planner will give a client the only advice that will insure he or she needs little or no future financial planning?

8. *Deferred Variable Annuity Design: Guaranteed Death Benefits*

While deferred variable annuities place the entire investment risk on the policyholder during the accumulation phase, a variety of benefits are provided under deferred variable annuity policies that operate to shift part of the risk back to the company.[149] If a contract owner dies during the

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146. Timothy C. Pfeifer et al., Session 138PD An Immediate Annuity with Casho-Out Rights?, Panel Discussion Before the Washington Annual Meeting of the Society of Actuaries (October 26-29, 1997), *in* 23 RECORD No.3, at 3-4. Sales agents generally prefer to sell deferred annuities rather than immediate annuities because of the difference in compensation. *Id.* at 3. Agents typically receive 1-5 percent commissions on immediate annuities and 5-7 percent commissions on deferred annuities. The moderator states: "Agents might not tell you publicly, but they might tell you privately about their belief that once they put their clients into an immediate annuity, there's no opportunity for them to earn any more commission from that business." *Id.* at 3-4. Thus, they encourage the purchase of deferred annuities "from which they intend to encourage systematic withdrawals." *Id.* at 3.

147. There are very likely some policyholders who purchased deferred annuities decades ago, before companies became very conservative in their mortality guarantees, who hold accumulating policies that would be very attractive to annuitize but do not realize that and continue to let them accumulate.

148. *See generally* Deanne L. Osgood et al., Session 95PD Variable Annuity Product Design, Panel Discussion Before the Maui I Spring Meeting of the Society of Actuaries (June 15-17, 1998), *in* 24 RECORD No.1 (discussing fee structures in variable annuities).

149. While these benefits are called guarantees, it is really somewhat of a misnomer. The concept of a guarantee usually contemplates a third party with assets who can be called upon to pay a liability if the primary obligor defaults. Here, there is no third party that guarantees these

accumulation period of a deferred annuity, state law generally requires the company to pay all or a portion of the contract's cash value to the owner's beneficiary as a death benefit.[150] The policy itself often provides for death benefits in excess of those required by state law. There are four types of such guaranteed minimum death benefits (GMDBs) currently provided under deferred variable annuities:

1. *Return of Premium:* This benefit pays the greater of (a) the sum of all premiums paid for the contract less any withdrawals and (b) the contract's cash value on the date of death.

2. *Periodic Step-Up:*[151] This benefit pays the greatest of (a) the sum of all premiums paid for the contract less any withdrawals; (b) the contract's cash value on the date of death; and (c) the contract's cash value on a specified date, referred to as the anniversary date, less any withdrawals.[152]

3. *Guaranteed Return:* This benefit pays the greater of (a) the contract's cash value on the date of death and (b) the sum of all premiums paid for the contract less any withdrawals plus interest at a specified rate.[153]

4. *Percentage of Gain:* This benefit pays the beneficiary a specified percentage of any gain in a contract, excess of cash value over premiums paid minus withdrawals, in addition to the contract value on the date of death.[154]

In some cases, policies offer combinations of these benefits, for example, the greater of a one-year step up and a 5 percent guaranteed

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benefits. Rather, it is the insurance company itself, the primary obligor of all benefits under the annuity policy, that is providing these additional benefits. It would be more accurate to call them additional contractual benefits than guarantees.

150. BLACK & SKIPPER, *supra* note 33, at 165-66.

151. This benefit is often referred to as a "maximum anniversary value" or "ratchet" death benefit.

152. Usually, the benefit is pegged to an annual anniversary date (a one year ratchet), but sometimes the benefit ratchets less frequently on the anniversary date (e.g., a two year ratchet would change every two years). If the benefit is pegged to the maximum value on any anniversary date, then it can never go down. If the benefit is merely reset to the value on each anniversary date (referred to as a "reset"), then the benefit can decrease. *See* Campbell & Ruark, *supra* note 66 (discussing the various guaranteed lifetime and death benefits on deferred variable annuities).

153. This benefit is called a premium "roll up." Initially, the rate was in the 1 to 3 percent range to approximate inflation, but it is now more common to see rates of up to 7 percent.

154. The benefit is usually subject to a cap. The benefit is designed to compensate, at least in part, for the fact that an annuity does not receive a step up in basis on death under section 1014 of the Code as do most other nonqualified investment assets. I.R.C. § 1014 (2002); *see also supra* note 54 and related text.

annual return. These benefits are provided for two principal reasons. First, since a deferred variable annuity places all of the investment risk on the contract owner, this may cause some risk-averse individuals to invest less aggressively than they perhaps should. The guaranteed minimum death benefits provide some protection against the risk of losing money during a market downturn, at least in the event of the death of the policyholder. This guarantee may provide an incentive for someone saving for retirement to invest more aggressively and accumulate a larger retirement fund. Since the death benefit only pays off to a beneficiary if the policyholder dies during the accumulation period, it doesn't protect the policyholder against the risk of investment losses that will reduce the level of annuity payments in retirement.

Second, companies offer these benefits to improve the persistency of their annuity policies. During the first several years a deferred annuity is in force, there is usually a surrender charge that applies. Typically, the surrender charge is 7 to 10 percent of the cash value in the first year and decreases by one percentage point per year until it vanishes. The periodic step-up death benefits were originally linked to the end of the surrender charge period on the theory that it might have some affect on a policyholder's decision whether or not to surrender the annuity or exchange it for an annuity with another company when the surrender charges were no longer applicable.[155]

Companies also offer such benefits to differentiate their products and gain a competitive edge. Benefits are perceived by insurance companies to be important to prospective purchasers of variable annuities; therefore, in a very competitive marketplace, companies routinely offer them. A few companies offer only the basic return of premium benefit but most offer enhanced death benefits. However, any competitive edge rarely lasts long since rival companies quickly adopt and offer any new benefits that are attractive to customers. Competitive pressure may explain why such benefits typically start out modest—a five year reset and a 2 percent roll up—but become more substantial—a one year ratchet and a 7 percent roll up—as competing companies continue to attempt to gain a competitive edge. A recent Wall Street Journal article cited a study that indicated that in 2001, 61 percent of gross annuity sales came from exchanges from one

155. BLACK & SKIPPER, *supra* note 33, at 169-70; ANNUITIES ANSWER BOOK, *supra* note 27, at Q 1:28, Q 2:42. A few deferred variable annuities do not have any surrender charges, but the vast majority of them do. BLACK & SKIPPER, *supra* note 33, at 170.

product to another instead of new money coming into the industry, up from 52 percent in 2000 and 20 percent in 1996.[156]

Guaranteed death benefits are an additional factor that may discourage ultimate annuitization by the purchasers of those policies. Since the death benefit pays off only if the contract owner dies before annuitizing, any contract with a death benefit that is "in the money," the death benefit exceeds the current cash value of the policy, will likely not be annnuitized until required under state law.

Since the risk of loss from investing over a long period of time in a broadly diversified fund is not substantial, one might also ask to whom these death benefits are being marketed. It is speculators and short-term traders who face the most risk from equity markets and who would likely purchase the product for its death benefits and tax deferral benefits with no intention of annuitizing it. If some of the funds supporting the annuity are overly risky even for long-term investors, the appropriate response is not to provide expensive insurance coverage to encourage investing in them but to eliminate the unsuitable fund choices.

The death benefits also provide non-optimal incentives to policyholders. Purchasers who have invested money in an annuity with poorly performing funds will find that their death benefit is "in the money." While they might otherwise rationally decide to exchange the annuity for another with better fund options, if they do, they will forfeit the accrued death benefit on the old annuity. Alternatively, they may decide to move the accumulation to a less risky account than they would otherwise choose and maintain the life insurance benefit, or they may be inclined to invest in the most aggressive fund choices within the investment menu options on the annuity they own in an attempt to get even, for any further losses will also be covered (at least at death) by the death benefit. Thus, they may be induced to continue investing in poorly performing funds or to invest either less or more aggressively than is consistent with their risk tolerance.[157]

In particular, the percentage of gain benefit is very troublesome. Its only function is to partially compensate for the fact that annuity accumulations do not receive a step-up in basis at death and make a deferred variable annuity a closer substitute for other non-annuity investment vehicles. What legitimate need do purchasers who are primarily concerned with providing

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156. Bridget O'Brian, *In Annuities, A Quest for Basics*, WALL ST. J, April 8, 2002, at R-23. Financial Research Corp., a Boston consulting firm, conducted the study. *Id.*

157. Ari J. Lindner et al., Session 23PD Risk Management Behind Variable Annuities, Panel Discussion Before the Sand Diego Spring Meeting of the Society of Actuaries (June 22-23, 2000) *in* 26 RECORD No.2, at 3. Actuaries assessing the risks of guaranteed death benefits assume that some policyholders will react in these ways. *Id.*

for their own retirement income have for insurance that will only be beneficial if they invest profitably during the accumulation phase but then never annuitize the contract? Having paid for this insurance during the accumulation phase and having invested profitably, how likely are they to annuitize and forfeit the value of the insurance benefit?

The death benefit is also likely to have the greatest negative impact on annuitization rates because, assuming most deferred annuities offer sound investment choices, the vast majority of contracts can be expected to be profitable at least over the long-term. Unlike the other death benefits, the percentage of gain death benefit will be "in the money" and discourage annuitization precisely when it has been effective in accomplishing its purpose of encouraging the policyholder to invest more aggressively.

The death benefits provided on variable annuities are also irrationally priced and nearly impossible to value. While they have some value in volatile equity markets, it is impossible to determine whether they are being reasonably priced; assessing and quantifying the risks and benefits requires complicated Monte Carlo simulations of financial market movements, policyholder mortality, and assumptions about likely policyholder behavior in the face of market volatility, tasks that are extremely difficult even for seasoned actuaries.[158]

The charges levied for these benefits vary. Even though they are not structured as separate life insurance benefits, they are a form of life insurance and logically the fee should vary with the age and sex of the policyholder, but it does not. Because the death benefits on deferred variable annuities are not structured as separate term life insurance, the beneficiaries who receive them may not exclude them from gross income as the beneficiaries of mutual fund death benefits do.[159] There are currently four mutual fund companies that offer a minimum guaranteed death benefit on some of their funds, and those benefits are structured as separate term life insurance benefits for which the premiums do vary by age and sex.[160]

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158. *See generally* Lindner et al., *supra* note 157 (discussing management of the risks of financial market volatility); Stephen J. Preston et al., Session 127PD Variable Annuities and Segregated Funds–Guaranteed Benefits Valuation Issues, Panel Discussion Before the San Francisco Annual Meeting of the Society of Actuaries (Oct. 17-20, 1999), *in* 25 RECORD No.3; Kenneally et al., Session 90 PD, *supra* note 116, at 4-8. *See also* Campbell & Ruark, *supra* note 66 (discussing computing statutory reserves for guaranteed benefits).

159. I.R.C. § 101 (West 2002). Life insurance benefits paid by reason of the death of the insured are excludible from the gross income of the beneficiary under section 101 of the Internal Revenue Code. *Id.*

160. Milevsky & Posner, *supra* note 116, at 98. The four mutual fund companies are Prudential Investments, SunAmerica, American Skandia, and Putnam Investments. *Id.* at 96.

In addition, one would expect that the fee charged for the death benefit would vary with the riskiness of the underlying investment funds, but it does not.[161] Insurance company actuaries are also unsure of what mortality assumptions to use in pricing and computing reserves for the guaranteed minimum death benefits.[162] Because mortality rates were not considered a key element in variable annuity profitability, companies did not collect data and perform detailed mortality studies and have not done so even after they began offering enhanced death benefits that substantially increased their risk exposure.[163]

A recently published study has concluded that the typical variable annuity mortality charge for the simple return of premium death benefit is likely five to ten times the economic value of the benefit.[164] In May 2000, Sidney and Johanna Olmsted, holders of Prudential variable annuities, brought a class action suit against the insurance company under certain provisions of the Investment Company Act, alleging that the contracts charged unreasonable mortality and expense risk fees.[165] One of the allegations was that the fees for the minimum death benefit were excessive because the benefit was virtually worthless.[166] While that case was

161. *Id.* at 98. Canadian mutual funds that offer such death benefits do impose fees that vary with the volatility of the assets in the fund. *Id.* For example, growth funds, compared to balanced or bond funds, are charged three to four times as much in fees. *Id.* The death benefits in deferred variable annuities do not insure any particular subaccount but rather the entire accumulation in the policy, which may be allocated and reallocated among several subaccounts. This policyholder choice makes it more difficult to assess the risks of the guarantee. Kenneth P. Mungan et al., Session 113PD, The Impact of Policyholder Behavior on Variable Annuities, Panel Discussion Before the Toronto Spring Meeting of the Society of Actuaries (June 20-22, 2001), *in* 27 RECORD No. 2, at 3.

162. There is a work group studying the issue. Darin C. Zimmerman et al., Session 118TS Guaranteed Death Benefits (GMDB) Reserving Modeling and Investment Implications, Panel Discussion Before the Washington Annual Meeting of the Society of Actuaries (Oct. 26-29, 1997), *in* RECORD No.3, at 19-20. It recommends the use of a group table—the 1994 Group Annuity Mortality basic table—increased by 10 percent for margins as the valuation table for reserve purposes for the time being. *Id.* at 19. The group sent out a series of questionnaires to participating companies concerning mortality experience to obtain data to possibly construct another table to use for those benefits. *Id.* at 20. The study was supposed to come out in 1997, but it hasn't yet been completed. *Id.*

163. Kenneth P. Mungan et al., Session 113PD The Impact of Policyholder Behavior on Variable Annuities, Panel Discussion Before the Toronto Spring Meeting of the Society of Actuaries (June 20-22, 2001), *in* 27 RECORD No. 2, at 17.

164. Milevsky & Posner, *supra* note 116, at 99-101. The study concludes that a typical fifty-year-old male should be charged no more than 3.5 basis points per year for the return of premium death benefit and no more than 20 basis points per year for a 5 percent annual roll up. *Id.* at 122. The comparable figures for a typical fifty-year-old female are 2 basis points and 11 basis points respectively. *Id.* The authors admit that they do not take into account reserving requirements, regulatory costs, agent commissions, and reasonable profits. *Id.*

165. Olmsted v. Pruco Life Ins. Co., 134 F.Supp.2d 508, 510 (E.D.N.Y. 2000).

166. *Id.*

dismissed by the district court on procedural grounds[167] and the dismissal was affirmed on appeal,[168] further litigation of the issue is likely.

Several other cases have been filed against insurers alleging inflated fees for death benefits on deferred variable annuities make the annuities unsuitable investments for tax-qualified plans. A deferred variable annuity is an unsuitable investment for a qualified retirement plan unless the death benefits or guaranteed annuitization rates are worth the additional expense charges levied on the variable annuity. The other major benefit of a deferred variable annuity, tax deferral of investment earnings, is unnecessary in a qualified plan since investment earnings from any source in such a plan are generally tax deferred. In pretrial discovery in one of those cases, Hartford Life claimed that it had paid only a single death benefit totaling $119 from 1983 through 1999.[169] Due to the recent market downturn, Hartford Life has paid significantly greater death benefits in the past two years, and John Waters, an executive vice president, was quoted as saying: "For years, people said you overpaid for the death benefit, it wasn't real, nobody needs it." He went on to say that in the current market environment, death benefits "really do have value."[170] Whether their value bears any rational relationship to the price being charged for them is still a matter in dispute. The fact that some death benefits have been paid out in two of the close to twenty years that the company has been offering the benefits provides no persuasive evidence that they were worth the substantial fees the company has collected over that time.

In summary, there is no rational basis for concluding that the fees charged for these benefits are reasonable even in the aggregate—to the entire pool of annuity purchasers. Even if they are reasonable, the current pricing structure implies that younger policyholders and policyholders who invest more conservatively are being forced to subsidize older policyholders

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167. *Id.* at 517. The district court dismissed the case on the ground that there was no implied private cause of action for damages under the statutory provisions relied upon. *Id.*

168. Olmsted v. Pruco Life Ins. Co., 283 F.3d 429, 436 (2nd Cir. 2002). Plaintiffs appealed and the SEC, at the invitation of the appellate court, filed an amicus brief. *Id.* at n.5. In the brief, it declined to address the issue presented by the plaintiffs because it argued that other provisions of the Investment Company Act provided potential relief and that it was therefore unnecessary to imply a private cause of action for damages under the sections relied on by the plaintiffs. *Id.* The appellate court affirmed the district court's dismissal but declined to reach the issue raised by the SEC because the plaintiff had not raised it in the lower court. *Id.*

169. Ron Panko, *Can Annuities Pass Muster?* BEST'S REVIEW 103, 108 (July 2000). From 1982 to 1995, the mortality and expense charge on its annuities was 125 basis points, but the charge was reduced in 1995. *Id.*

170. Bridget O'Brian, *Annuity Sellers Make Grim* Pitch, WALL ST. J., July 8, 2002, at R23. In 2000 and 2001, Hartford Life paid death benefits of $30 million and $101.5 million, but in prior years the number was negligible. *Id.*

and policyholders who invest more aggressively. Such anomalous pricing of benefits in a tax-advantaged product is a serious tax policy concern.

D. SUMMARY

Annuitization provides significant benefits and should be encouraged. Factors favoring the probability of annuitization of deferred variable annuities include the fact that the annuity payout is an option in the deferred annuity contract itself, the availability of a variable payout option to address the inflation issue, and the possibility of educational efforts by insurance companies to better explain the benefits of annuitization and encourage its use. Unfortunately, to date there has been very little effort on the part of insurance companies to encourage annuitization, and there is little economic incentive for them to do so. Unattractive payout pricing due to adverse selection, strong psychological resistance to annuitization, and the likely behavioral effects of annuity death benefits are major factors that are likely to discourage voluntary annuitization. In short, since annuitization of deferred variable annuities is voluntary and since there is no evidence that any large percentage of owners will voluntarily annuitize, the annuitization aspects of deferred variable annuities do not provide any persuasive reason to grant them special tax status.

IV. THE ACCUMULATION PHASE: SAVINGS AND INVESTMENT

A. INTRODUCTION

Policymakers are interested in identifying strategies to stimulate increased levels of individual savings, particularly in the United States, which has very low savings rates both by historical standards and by comparison to other developed countries. Policymakers are also interested in encouraging optimal investment methods so that whatever amounts are saved will produce accumulations sufficient to provide adequate levels of consumption in retirement. If nonqualified deferred variable annuities are effective in increasing savings or in encouraging optimal investment, then those welfare benefits might be sufficient justification for their special tax status. This section will discuss the current theory and evidence with respect to the likely impact of targeted tax advantages on savings and investment in general and through nonqualified deferred variable annuities in particular.

B. EFFECTS OF TARGETED TAX INCENTIVES ON SAVINGS

1. Introduction

Whether the economic benefits of income tax incentives have any effect on the level of private savings is unclear, even with respect to the most favored savings plans: qualified retirement plans. Tax benefits on savings lower the cost of future consumption, which may cause an individual to spend less on consumption today and save more to take advantage of the cheaper future consumption. But tax benefits also raise the rate of return on the investment, which makes it possible to reach one's goal by saving less. Economists refer to saving's sensitivity to the after tax rate of return as the "interest elasticity of saving." It can be positive, neutral, or negative; theoretically saving could rise, remain the same, or fall in response to an increase in the after tax rate of return caused by favorable tax provisions, depending upon the relative magnitudes of the two opposing effects. There is no theoretical presumption that either effect will dominate.[171]

Because economic theory alone cannot provide a persuasive rationale for most savings tax incentives, proponents have suggested a number of behavioral rationales to support them. Behavioral economists argue that it is clear that something besides pure mathematical calculation is involved in savings decisions. The clearest evidence of this is the fact that pension wealth in the form of a defined benefit plan that cannot be accessed before retirement and gives the employee no choice as to participation or level of benefits has an anomalous effect on savings behavior. Standard economic theory would predict that an individual with such a benefit would take it into account in making other savings decisions and would reduce other savings by the value of the benefit. However, contrary to that prediction, the existence of such a benefit seems to have either no effect or a positive effect on the level of other savings. In other words, contrary to the predictions of standard theory, the presence of such wealth may actually be accompanied by an increase in other savings rather than a decrease.[172]

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171. BERNHEIM, *supra* note 1, at 5.

172. *See* Richard H. Thaler & H.M. Shefrin, *An Economic Theory of Self-Control*, 89 J. OF POLITICAL ECON. 392, 399-400 (citing studies conducted in the 1960s and 1970s); Richard H. Thaler, *Anomalies: Saving, Fungibility, and Mental Accounts*, 4 J. OF ECON. PERSP. 193, 199 (1990). While the tax benefits accorded qualified pension plans are substantial, there are also substantial non-tax reasons why employers set up pension plans. They may reduce voluntary job turnover, make union activity less necessary and less likely, and induce a desired pattern of retirement. Thus a private pension system might well exist without tax incentives. BERNHEIM, *supra* note 1, at 81.

Individuals simply do not treat such wealth the same as other forms of wealth. Furthermore, even if such retirement plans did not have clear positive effects on savings, the other substantial benefits provided by them, including placing investment risks and longevity risks on the employer might well justify granting them tax-advantaged status.

Unfortunately, such plans are now offered by relatively few employers, and the majority of qualified plans are now of the defined contribution type, which are somewhat more liquid and are voluntary rather than mandatory.[173] Behavioral economists have analyzed such plans with a view toward ascertaining what features might best induce employees to participate in these plans. Unlike traditional economists, who focus solely on economic features, behavioral economists analyze such plans from a psychological point of view.

It is important to distinguish whether behavioral rather than purely economic incentives motivate individuals to save because that will affect the optimal design of incentive savings plans. If individuals respond positively to features of a plan other than the tax benefits, then the plan should be designed to strengthen the behavioral features rather than merely provide additional costly tax benefits. For example, while a savings plan may not result in new saving, its commitment aspects may discourage backsliding and thereby result in a greater level of savings in the long run. Such behaviorally sensitive plans may be more effective in increasing saving and yet be less costly from a revenue loss standpoint than other tax-advantaged plans.

In particular, the choice between broad-based and narrowly focused tax reforms to encourage savings will be strongly influenced by whether behavioral affects are determined to be important. If only economic effects are considered important, then a pure consumption tax would be expected to be most effective: it raises the marginal after tax rate of return on all savings and avoids the considerable administrative complexities of targeted plans. If behavioral effects are more important than merely raising the after tax rate of return, then narrowly focused savings policies that are designed to accomplish targeted behavioral objectives have the greatest likelihood of

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173. Engen & Lehnert, *supra* note 17, at 803. As defined contribution plans became more common, the percentage that were 401(k) plans rose and reached 78 percent in 1998. *Id.* Unlike IRAs, 401(k) plans are available only to employees of firms that choose to set up a plan, and employers may make contributions to employees' accounts in the plan. *Id.* Similar kinds of defined benefit plans are available to employees of nonprofit institutions (403(b) plans) and state and local governments (457 plans). *Id.* at 803 n.23. Employers select the investment options available in 401(k) plans, and the number of options is typically modest. *Id.* at 803; *see also* Eric M. Engen et al., *Do Savings Incentives Work?*, 1 Brookings Papers on Economic Activity 85-150 (1994) (discussing 401(k) plans).

successfully modifying behavior. Narrow measures can focus attention on a particular issue such as retirement savings, stimulate the provision of information concerning the importance of saving, provide a natural context for the development of commitment devices, and promote the growth of pro-saving institutions.[174] As a political matter, it is unlikely that we will see a wholesale shift to a consumption tax in the near future in this country. Therefore, normative analysis of tax-advantaged savings plans in this article will proceed from the assumption that the general rule is taxation of income from capital, and that exceptions must be justified on policy grounds.

Behavioral economics principles have important and provocative suggestions for optimal design of savings incentives systems. The naïve assumption that the economic benefits provided by tax advantages are the sole or even primary determinant of the success of the plan in stimulating saving or investment does not withstand careful analysis. Much of the revenue loss resulting from many targeted savings incentives might simply be wasted if the plans are not required to be designed and implemented in a manner that takes into account behavioral and psychological principles with respect to savings and investment decisions.

Behavioral economists have identified a number of possible errors in the underlying assumptions about behavior used in standard economic models that are used to simulate the life cycle savings behavior of individuals and suggest that those erroneous assumptions result in flawed predictions about the likely effect of tax-advantaged savings plans on behavior. They argue that tax-advantaged plans designed with the correct behavioral assumptions will be more effective and perhaps less costly. While systematic study of these issues is relatively recent and the field is still unsettled, some useful principles have been developed.[175]

2. *Needless Complexity and Conflict Among Experts*

Two of the hallmarks of any effective savings incentive plan intended for use by large numbers of participants with varying degrees of sophistication are that it be simple to use and understand and that it be judged to be

174. BERNHEIM, *supra* note 1, at 45.

175. BERNHEIM, *supra* note 1, at 39-40; *see also* HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 7-10 (Harvard Business School Press 2000) [hereinafter GREED & FEAR] (explaining the history of the development of behavioral finance). While behavioral economics principles are not yet fully developed, their importance was recognized by the award of the 2002 Nobel Prize in economics to two behavioral economists, Daniel Kahneman, a professor of psychology and public affairs at Princeton University, and Vernon L. Smith, a professor of economics and law at George Mason University.

a sound program by most experts.[176] Needless complexity increases deliberation time and greatly increases the possibility of costly error.

The authorities are split on whether a deferred variable annuity is an appropriate vehicle to use to accumulate needed additional retirement savings. It is difficult to provide an example of a tax-advantaged savings plan that has engendered such a diverse array of expert opinion. While IRAs and 401(k)s are overwhelmingly considered sound and desirable vehicles for almost all households, the same cannot be said of deferred variable annuities. In fact, the debate often rises to the level of invective. Even mainstream financial sources routinely provide material highly critical of deferred variable annuities, with provocative titles like "The great annuity rip-off"[177] and "Just Say No To Annuities."[178]

The current design of the typical deferred variable annuity is completely at odds with sound behavioral economic principles. Investment risk and responsibility for investment choice is borne by the policyholder, and there is a need to monitor the investments over time, particularly if the accumulation phase is lengthy. The bewildering array of choices offered by many companies often makes the task particularly difficult. It is impossible for any prospective purchasers, no matter how sophisticated and knowledgeable they may be, to determine whether the fees charged for the various benefits are reasonable. One of the supposed major benefits of a deferred annuity, the guaranteed mortality rates, are of dubious value; they are generally ignored by valuation actuaries, the experts relied upon by insurance companies in pricing the product. The other major insurance benefits provided under a deferred variable annuity, the guaranteed minimum death benefits, are irrationally priced, extremely difficult to value to determine whether they are even reasonably priced in the aggregate, and are provided in such a way that they are denied one of the major tax benefits otherwise accorded to life insurance benefits, excludability from the beneficiary's gross income. It can hardly be said that the product is suitable for widespread adoption by large numbers of individuals with varying degrees of sophistication.[179]

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176. Richard H. Thaler, *Psychology and Savings Policies*, 84(2) AM. ECON. REV. 186, 189 (1994).

177. Carolyn T. Geer, *The Great Annuity Rip-Off*, FORBES, Feb. 9, 1998, at 106.

178. David Franceki, *Just Say No To Annuities*, BARRONS, March 27, 2000, at R12.

179. The NASD has cautioned that for some customers, annuities might be unsuitable investments. *NASD Regulation Reminds Members And Associated Persons That Sales Of Variable Products Are Subject to NASD Suitability Requirements*, NASD NOTICE TO MEMBERS 98-86, (Nat'l Ass'n of Sec. Dealers Inc.) Dec. 1996, at 705-06. It mentioned factors, including the customer's inability to fully appreciate how much of the purchase price or premium is allocated to cover insurance or other costs, the customer's ability to understand the complexity of variable

The SEC was so concerned that it issued a publication available on its web site entitled *Variable Annuities: What You Should Know* to alert investors to several salient issues, including the various charges levied on annuities, the wisdom of purchasing an annuity in a qualified retirement account, evaluating the benefits and costs of exchanging one annuity for another, and evaluating investment subaccount options. The SEC has expressed concern over "how to insure that useful, and not merely overwhelming, disclosure reaches investors when products may have 25 or 30 investment options"[180] The best advice the SEC can offer in that regard in its pamphlet is to refer the annuity purchaser to SEC publications on mutual funds.

Much of the costs of annuities are selling costs, and much of the selling costs are attributable to the fact that it is sold in a highly competitive environment as one option in competition with other investments. The SEC is perennially concerned with insuring that the vigorous competition works to the benefit of investors and is particularly concerned that the recent market downturn may intensify the competitive environment and spur a "race to the bottom."[181] The fact that over half of deferred variable annuity sales are now merely exchanges from already existing contracts is strong evidence that the competition is extremely fierce.

This competitive frenzy has been fueled in large part by the very amorphous definition of a nonqualified annuity that permits companies to continue to reinvent the wheel, adding various bells and whistles to gain a competitive edge. These constant redesigns are expensive, and the companies seek to recover those costs through charges that make the product more expensive than it otherwise would be. With the exception of some of the newer guaranteed minimum income benefits, the competition has focused in the past almost exclusively on death benefits and investments choices.

Competition with mutual funds and with other variable annuities has substantially driven the number and kinds of investment choices. It is no coincidence that specialized accounts like asset allocation accounts and sector accounts (e.g., technology, precious metals, energy, etc.) first appeared in variable annuities at about the same time they appeared in the

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products generally, the customer's investment sophistication, and whether he or she is able to monitor the investment experience in the separate account, as factors to consider in determining whether a variable annuity is a suitable investment. *Id.*

180. Paul F. Roye, Remarks at the ALI-ABA Conference on Life Insurance Products: Current Securities, Tax, ERISA, and State Regulatory Issues (Nov. 11, 1999) (transcript *available at* hhtp://www.sec.gov/news/speech/speecharchive/1999/spch.317.htm).

181. Paul F. Roye, Remarks Before the National Association of Variable Annuities 2001 Regulatory Affairs Conference (June 25, 2001) (transcript *available at* http://www.sec.gov/news/speech/spch501.htm).

mutual fund universe. Once one annuity insurer expands its investment choices, most others are quick to follow. With no meaningful tax law restrictions on investment choices, this expansion has resulted in the typical annuity offering 15 to 30 subaccounts, and some offer even more. Whether this additional choice has benefited annuity purchasers is not clear; although behavioral principles suggest it probably hasn't.[182]

Competitive pressures in the variable annuity market have produced an extremely complicated product that is hard to sell, for reasons aside from the general problem of selling retirement savings vehicles to a consuming society. It is the needlessly complicated, often irrational, and costly aspects of variable annuities that make the product the subject of so much difference of opinion among financial experts. Whenever the mainstream financial press produces another article castigating variable annuities, the industry responds with costly and time consuming counter-advertising. The conflicting expert opinions not only confuse the public but add significantly to the costs of the product, making it an even harder sell.

While complexity may sometimes be unavoidable, needless and costly complexity is counterproductive. John H. Biggs, Chairman and CEO of TIAA-CREF, who was in the vanguard of the development of deferred variable annuities, summed it up succinctly in 1969 before the explosive growth of the product. He stated: "It is the author's view that strenuous efforts should be made to purge variable annuity contracts of unnecessary complications, particularly in those aspects that must be communicated to the public."[183] Unfortunately, the industry did not heed his warnings.

Those selling deferred variable annuities also do not do a good job of explaining the complexities of the product to prospective purchasers. A recent Wall street Journal article discussed the advice given by Annuity University, a two-day seminar for sales people on how to sell annuities to senior citizens.[184] A key piece of advice given by Tyrone Clark, the

182. One thing this additional choice has contributed to is the prevalence of annuity purchasers who adopt market timing strategies or sector rotation strategies in an attempt to beat the broad market averages. Such activities impose additional costs on the subaccounts that are borne by all investors in those funds, whether they are engaged in those activities or not. Deferred annuities are particularly attractive to account holders pursuing such strategies because of the deferral of tax on any gains realized on transfers between subaccounts. Companies have responded with policies to discourage such tactics, such as imposing redemption fees for account holders who transfer amounts among subaccounts on a short term basis according to market timing strategies and requiring account holders who make frequent transfers to conduct exchanges by mail; the SEC has looked favorably on such responses. *See* Paul F. Roye, Keynote Address Before the National Association of Variable Annuities, 2002 Regulatory Affairs Conference (June 24, 2002) (transcript *available at* http://www.sec.gov/news/ speech/spch572.htm).

183. Biggs, *supra* note 115, at 517.

184. Ellen E. Schultz & Jeff D. Opdyke, *Annuities 101: How to Sell to Senior Citizens*, WALL ST. J., July 2, 2002 at C1, C10.

president of the company that runs Annuity University, was the following: "Treat them like they're blind 12-year-olds."[185] While maintaining that his techniques were not designed to belittle seniors or to help agents persuade seniors to make unsuitable investments, he stated, "It's just that agents can come across as too technical [when pitching an annuity] and people don't understand them . . . I use metaphors to show them they have to oversimplify the information."[186] Trainees also learn that educational seminars can be used to generate fear among the seniors attending. Mr. Clark tells the trainees to "[t]oss hand grenades into the advice to disturb the seniors. They thrive on fear, anger and greed;" whatever the retiree's particular concern—taxes, investment returns, or asset protection—the solution is almost always the same: an annuity.[187] Unfortunately, many of the complexities that are often glossed over or simplified are undoubtedly those that would tend to indicate that an annuity is not particularly suitable for that person: the negative tax attributes, the illiquidity of the investment due to surrender charges, large insurance costs for very weak mortality guarantees, and irrationally priced death benefits.

This is not just a problem with one company providing training sessions for sales agents. Similar sales tactics are commonplace. Most annuities are sold through independent agents, banks, and wirehouses and brokerage firms, often on a commission basis. Annuities are sold primarily, if not solely, as an attractive tax advantaged substitute for other investment options such as mutual funds.[188] Since the tax deferral benefit is more

185. *Id.* at C1.

186. *Id.*

187. *Id.* at C10.

188. Mark A. Milton et al., Session 152PD How Annuities Are Really Sold, Panel Discussion Before the Washington Annual Meeting of the Society of Actuaries (Oct. 26-29, 1997), *in* 23 RECORD No.3, 15-24. Linda Need, a vice president and national sales director for Northbrook Life Insurance Company, summed it up well in a presentation in 1997 at the annual meeting of the Society of Actuaries. *Id.* In discussing sales through wirehouses and brokerage firms, she stated:

> When you're selling in a representative dealer, and you're selling VAs [variable annuities], there are five simple things that drive that sales [sic]. First, upside potential of being in equity mutual funds. Second, downside protection. That's our euphemism for the death benefit. You can't say death benefit in a representative dealer. That's bad news. If you really think about it, what's good about dying? Third, tax deferral is obviously one of the drivers. Fourth and fifth, probate avoidance is one of the drivers, and liquidity can be a driver, although it's a fifth runner. What you will find is that any good sales idea that works and is compliance approved is one of these five things or a combination of them, but when you dig deep into any sales ideas you will find these sitting right behind them. What are some sales ideas that work? Sales idea number one—VAs are just a better mutual fund. A typical question a representative will ask their client is do you own any mutual funds? Oh, you do. Do you own the old or new kind? What do you mean? They always ask what do you mean? Well do you have the kind that you pay taxes on every year or the kind that you don't have to

proximate and the negative tax and non-tax aspects of the product are more remote, it is easy to downplay the latter and stress the former, even though this often results in purchases of annuities by persons for whom they are very likely unsuitable investments.[189]

There is also a serious problem of marketing deferred annuities to tax qualified plans. One of the main benefits of a deferred annuity, the tax deferral of any investment gains, is unnecessary in tax-qualified plans because all investment gains are deferred anyway. Since distributions from qualified plans are taxed as ordinary income, receive no step-up in basis at death, and are subject to early withdrawal penalties, those negative tax attributes of annuities will not deter purchases of deferred annuities in qualified plans. However, deferred variable annuities have much higher expenses than most other alternative investments, and the only possible benefits of purchasing a deferred annuity rather than mutual funds in a qualified plan are the mortality payout guarantees, the death benefits, and the guarantee that the administrative fees charged under the contract will not increase during the life of the contract.[190] Given the weakness of the payout guarantees and the fact that the death benefits are irrationally priced, it is hard to imagine that the large volume of purchases of deferred annuities in qualified plans—over 50 percent of sales[191]—is suitable in most cases. The Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) have issued cautions warning

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> pay taxes on until you take the money out? I didn't know you had that kind. Sale closed. It's that simple. Many clients have the same mutual fund choices inside and outside the VA. If you're not going to spend the money, why pay taxes? This is one of my favorite lines, and it is not a compliance approvable line, by the way. When compliance got to this it turned into about [ten] sentences. Wise people don't pay taxes on their interest. They earn interest on their taxes. Compliance has you add a whole bunch of other words, but it's really kind of nice . . . .

Id. at 24-25.

Ms. Need went on to say while her number one sales idea for getting clients to commit assets was "stealing money from mutual funds," her number two idea was emphasizing the death benefit as a form of insurance of investment that she characterized as getting clients' assets by "stealing them from any place they came." *Id.* Her third idea was to induce clients to shift funds from an existing variable annuity at another company by offering better death benefits or other features "to steal them [assets] from old annuities." *Id.* at 25.

189. The Massachusetts Department of Securities recently announced that it was taking action against two firms some of whose agents had been trained at Annuity University. Bruce Mohl, *State to Accuse Two Firms of Preying on the Elderly*, BOSTON GLOBE, Sept. 25, 2002, at C1, C5. Many of the complaints involved selling deferred annuities to elderly individuals, one of whom was a 103-year old woman. *Id.*

190. This last guarantee is standard on all variable annuities. An insurance company's obligations under a deferred annuity may extend over many decades, and the company guarantees that the costs of administering the contract and maintaining the separate account will not increase over that time. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 1:23. Since the fee for this guarantee is not separately stated, it is difficult to assess its reasonableness.

191. Milevsky & Posner, *supra* note 116, at 92.

that deferred variable annuities may often be unsuitable investments in a tax-sheltered account.[192] Lawsuits were instituted against five insurers alleging inappropriate sales of variable annuities for qualified retirement plans, one of which has been settled.[193]

3. *Other Behavioral Aspects of Deferred Variable Annuities*

An incentive plan can have a positive effect on savings in a number of ways, including the following: (1) by changing perceptions concerning the costs and benefits of savings;[194] (2) by providing the opinion of experts on the need for greater savings;[195] (3) by providing explicit commitment devices, such as penalties for early withdrawal;[196] (4) by encouraging the development of private commitment devices, such as "private rules" to

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192. *Variable Annuities: What You Should Know*, United States Securities and Exchange Commission (*available at* www.sec.gov/investors/alerts.html) (last visited Aug. 8, 2003); *The NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities*, NASD NOTICE TO MEMBERS 99-35 (Nat'l Ass'n of Sec. Dealers, Inc.) May 1999.

193. Panko, *supra* note 169, at 104.

194. BERNHEIM, *supra* note 1, at 41. When a savings incentive is in place, individuals may be more likely to learn that others regard savings as important, and these effects are most likely to be present in the case of an employment based savings plan. *Id.* There is considerable evidence that economic decisions in general are strongly affected by peer group effects involving both demonstration and competition. *Id.* at n.32. A savings plan would be most effective if it also reinforced a strong social norm favoring saving. *See* John Elster, *Social Norms and Economic Theory*, 3 J. OF ECON. PERSP. 99 (1989) (discussing social norms in general); Assar Lindbeck, *Incentives and Social Norms in Household Behavior*, 87 AM. ECON. R. 370 (1997) (discussing saving and consumption norms).

In addition, a savings incentive that includes a reduction of current tax liability, a "front loaded" incentive, may even be attractive to one who does not value the less immediate welfare benefits of wealth accumulation. BERNHEIM, *supra* note 1, at 42; *see also* Leonard E. Burnham et al., *The Taxation of Retirement Saving: Choosing Between Front-Loaded and Back Loaded Options*, 54 NAT'L TAX J. 689, 700-01 (2001).

195. BERNHEIM, *supra* note 1, at 88-89. Educational and promotional activities by employers and sellers of financial products would communicate the advice of the experts. *Id.* If there are contribution limits in the plan, these may be perceived to reflect the judgment of experts as to the proper level of savings. *Id.* at 41.

196. *See* Thaler, *supra* note 172, at 200 (explaining that in the case of retirement savings, the wealth once saved may be regarded as not available for consumption because the account becomes less liquid and because of restrictions on withdrawals and penalties for early withdrawal.) In other words, illiquid assets may actually be preferred over liquid assets by those who have self-control problems. *Id.* Savers who are aware of their self-control problems place significant value on external control mechanisms such as penalties for early withdrawal. *Id.* Commitment devices are most valuable to consumers with self-control problems due to time inconsistent preferences (hyperbolic discounters). A recent paper concluded that the commitment features of 401(k) plans, including automatic contributions through wage withholding, penalties for early withdrawal, and the fact that any withdrawn funds cannot be paid back into the account substantially increases the savings of such individuals. *See generally* David I. Laibson et al., *Self-Control and Saving for Retirement*, 1 BROOKINGS PAPERS ON ECONOMIC OPPORTUNITY 91 (1998) (quantifying the effect of commitment devices on savings behavior).

overcome lack of self-control;[197] (5) by encouraging broad based participation through plan requirements;[198] and (6) indirectly by influencing

197. Private rules are internal rules designed to overcome problems of self-control. Matthew Rabin, *Psychology and Economics*, 36 J. OF ECON. LITERATURE 11, at 40 (1998); George Ainslie, *Derivation of "Rational" Economic Behavior from Hyperbolic Discount Curves*, 81 AM. ECON. R. 334, 336-337 (1991). Individuals may overcome impulsive tendencies by attaching global significance to small transgressions of these rules. Stephen J. Hoch & George F. Lowenstein, *Time Inconsistent Preferences and Consumer Self-Control*, 17(4) J. OF CONSUMER RES. 492, 502-03 (1991). Savings incentives may facilitate the formation of private rules on saving by providing a natural context for developing rules concerning the level of savings, such as an incentive plan that has a maximum allowable contribution that could facilitate a rule to contribute the maximum. BERNHEIM, *supra* note 1, at 43. The plan may provide limited commitment devices to implement savings decisions such as 401(k) plans that permit employees to have amounts automatically deducted from their every pay period. *Id.* The effectiveness of these private rules will be reinforced by "mental accounting" whereby the individual treats the account as off limits to current spending except in emergencies, by the existence of penalties for early withdrawal, and by the ability to monitor progress toward a long-term savings goal. Thaler, *supra* note 172, at 194; *see also* Thaler & Shefrin, *supra* note 172, at 397 (stating that just keeping track of savings seems to deter diverting it to consumption). The fact that assets may be placed in separate mental accounts from which there is a lower propensity to consume does not necessarily mean that these accounts comprise new savings. Even if the tax advantaged account does not represent new savings but rather amounts transferred from other savings accounts, the transfer could result in higher wealth accumulation in the long run for the individual because the propensity to consume from the tax advantaged account is smaller than the propensity to consume from the other savings account. *See* Richard H. Thaler, *supra* note 172, at 230.

198. BERNHEIM, *supra* note 1, at 44. The best example is the non-discrimination requirements of qualified pension plans. *Id.* Since they may not discriminate in favor of the highly compensated, either in design or in operation, employers have an interest in encouraging participation by non-highly compensated employees. *Id.* If these employees do not participate because they do not understand the necessity of forming and executing a long-term savings plan, then educational efforts by the employer may be successful in getting them to participate or increase the level of their participation. *Id.*

Recently, employers have used behavioral economics principles to design their plans to encourage more participation by low and moderate income employees and employees who have difficulty saving because of self-control problems. *See* Richard H. Thaler & Schlomo Benartzi, Save More Tomorrow: Using Behavioral Economics to Increase Employee Savings, (University of California-Los Angeles Working Paper, August 2001) (describing a program that offered expert advice to employees to help them approximate the optimal savings rate in a simple, straightforward way and permitted employees who expressed no willingness to begin saving right away to increase savings periodically in the future, starting with the due date of the next pay raise and increasing with each subsequent pay raise). Since the increased savings occurs in the future, there is no perceived loss through lowering of take home pay and usual consumption levels. *Id.* In the retirement plan in which it was tested, it was extremely popular with participants, who saved significantly more than they previously had. *Id.* Even though such programs seem to have a very positive affect on savings rates, that conclusion may not be entirely accurate. If the increased qualified plan contributions rates are offset by other spending, such as high interest credit card debt or the additional contributions are later reduced by withdrawals or plan loans, then the net effect of such programs on personal saving may be neutral or even negative. JAMES J. CHOI ET AL., DEFINED CONTRIBUTION PENSIONS: PLAN RULES, PARTICIPANT DECISIONS, AND THE PATH OF LEAST RESISTANCE 18 (Nat'l Bureau of Econ. Research, Working Paper No. 8655, 2001).

Ironically, participation by low and middle-income employees may not always be in their best interests. *See* JAGADEESH GOKHALE ET AL., DOES PARTICIPATION IN A 401(K) RAISE YOUR LIFETIME TAXES (Nat'l Bureau of Econ. Research, Working Paper No. 8341, 2001). A recent study has concluded that a sizable number of moderate income households do not even economically benefit from deferring income during their working years to their retirement years,

the actions of third parties, such as employers and sellers of tax advantaged plans, who can provide education and other incentives to participate in the plan.[199] Deferred variable annuities are not designed with these principles in mind.

While the existence of an employment related, tax-advantaged plan can affect perceptions about saving and investment by stimulating useful conversations among employees about the importance of savings and investment, there is no easy mechanism whereby such peer group interactions can be provided to purchasers of annuities. Similarly, employers can more easily provide educational seminars on saving and investment to their employees than insurance companies can provide to purchasers of annuities. Because of the non-discrimination rules that apply to qualified retirement plans, employers also have an incentive to encourage broad participation among employees, and some of them have begun to utilize behavioral economics principles to do so.[200] Unlike qualified retirement plans, deferred variable annuities are not subject to any non-discrimination requirements. As a result, insurance companies have little incentive to target deferred annuities to individuals with lesser amounts of wealth to invest, who would gain the greatest incremental welfare benefits from them. In fact, it is likely that insurance companies prefer a smaller number of large polices to a large number of small policies.

Tax advantaged plans can have the effect of enhancing a saver's perception of the short-term effects of savings, but the example usually given

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even in the case of the most tax advantaged deferral mechanisms—qualified 401(k) plans. *Id.* at 25. Some moderate income individuals lose some of the current tax benefits on itemized deductions by deferring otherwise high taxed income, and the deferred income may result in increased taxes on Social Security benefits in the retirement years under current Code provisions. *Id.* at 26. The combined effects of reducing the value of current itemized deductions and increasing later income tax on social security benefits results in a somewhat greater total tax burden than foregoing the deferral and saving in a non-tax advantaged vehicle. This would most likely occur only in a plan with no employer match. *Id.* at 28.

199. BERNHEIM, *supra* note 1, at 43-45. The sellers of tax-advantaged plans and the sellers of financial publications have an incentive to provide education through advertising and other promotional activities to increase their sales. *Id.* The example usually given is the advertising and media fanfare that accompanied the expansion of eligibility for deductible IRAs in 1981. *Id.*

An important aspect of education is getting employees to focus on planning for retirement. Numerous studies document the importance of planning for retirement. Those who plan for retirement are significantly more likely to enter retirement with sufficient assets to avoid a drop in their accustomed standard of living. *See* John Ameriks et.al., *Wealth Accumulation and the Propensity to Plan* (TIAA-CREF Inst. New York, N.Y. Working Paper Preliminary Draft), April 2002. The paper concludes that a propensity to plan increases wealth by being associated with monitoring of spending, resulting in increased saving and more sophisticated investment decisions resulting in higher returns on savings. *See* LUSARDI, *supra* note 4 at 103 (concluding, based on data from the Household and Retirement Study (HRS), that lack of retirement planning is strongly associated with meager wealth accumulation).

200. *See* Thaler & Benartzi, *supra* note 199.

is that of a plan that provides an immediate tax benefit that lowers current tax liability, a "front-loaded" plan.[201] For example, an individual may be more inclined to make a contribution to an IRA if it is tax deductible and therefore will immediately result in a lower income tax liability. This argument has no application to a contribution to a nonqualified annuity because contributions are not tax deductible. Lesser tax benefits, like those accorded to nonqualified deferred annuities, are unlikely to stimulate significant new savings but rather merely provide an incentive to do whatever savings is done through the tax advantaged vehicle.[202]

Like any other tax-advantaged savings accumulation plan, deferred annuities provide an easy means of monitoring progress by segregating the savings account and providing periodic reports. How annuities facilitate the formation of private rules is more difficult to see. Private rules are best facilitated by plans that have design requirements, such as annual limits on contributions, which facilitate the formation of such rules. There are no such design requirements for deferred variable annuities, nor have the insurance companies chosen to voluntarily implement any design features that might strengthen the behavioral aspects of the product. Since deferred variable annuities are heavily marketed as merely alternatives to other investments, it is difficult to see how they could have any different or more positive psychological effects on savings and investment than the marketing and availability of those other non-tax favored investments.

Nonqualified annuities also lack the strong commitment aspects of many qualified plans, in particular annual limits on contributions, automatic withholding of contributions from the employee's pay, and prohibition of withdrawals until termination of employment.[203] Annuitization is an

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201. *See* Burnham et al., *supra* note 194 (discussing the varying incentive effects of "front-loaded" as opposed to "back-loaded" plans). In a front-loaded plan, contributions are tax-deductible, account balances accrue tax free, and qualified withdrawals are taxed as ordinary income, while in a back-loaded plan, contributions are not deductible. *Id.* at 689. Some back-loaded plans, like the Roth IRA, do not tax withdrawals. *Id.* Nonqualified annuities are weaker versions of back-loaded plans since income that accrues during accumulation is taxed on pay out. *Id.*

202. *Id.*

203. Lack of limits on contributions to annuities makes them less valuable as commitment devices, which are important to many individuals, particularly those with self-control problems. One virtue of contribution limits is that they increase the cost of delay or backsliding. For example, if there is a limit of $2,000 per year on contributions to a tax advantaged plan, with no catch up provisions, then a contribution not made in any year cannot thereafter be placed in the tax- advantaged plan. With no annual contribution limits, missed contributions can always be made up later, lowering the cost of backsliding and withdrawing money from the tax-advantaged plan. While there are penalties on early withdrawals from annuities for some policyholders, these penalties are muted by the fact that withdrawn amounts may be recontributed later.

The lack of any limits on contributions to deferred annuities may also provide an incentive to procrastinate in saving for retirement through nondeductible traditional IRAs. A nonqualified

important and valuable commitment device providing valuable protection against overspending due to lack of self-control. However, the annuitization rates of deferred variable annuities as currently designed are very low and are unlikely to substantially increase for the reasons already discussed in part III of this article. The lack of any penalties on withdrawals after age 59 1/2 provides no incentive to encourage pay out options that protect policyholders against outliving their assets.

Any beneficial third-party effects of the special tax status of nonqualified annuities are muted at best. The tax benefits accorded to annuities are an important factor in successfully marketing them.[204] The demand created by the tax benefits provides an incentive to insurance companies to promote the product,[205] and nonqualified annuities are also very heavily advertised and promoted by insurance companies. Tax qualification is most likely to have positive incentive effects on the actions of providers when the plan is simple and focused, therefore easy to promote. The basic concept of a deferred variable annuity is difficult enough without the added complexity of a bewildering array of guaranteed benefits and often an even more bewildering array of investment choices. The lack of any comprehensive tax law definition of a deferred variable annuity has permitted insurers to provide features more designed to gain a competitive advantage for their product than to enhance the savings, investment, and annuitization aspects of the product.

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deferred annuity is an almost perfect substitute for a nondeductible traditional IRA, except that it does not require any consistent periodic saving. The contribution to a nondeductible traditional IRA produces no immediate tax benefit, but income earned on the contribution is deferred from taxation until distributed. This is the identical treatment of a nonqualified annuity—premiums are nondeductible but earnings are deferred. The only difference is that there are mortality charges levied on the deferred annuity and higher expenses. There is psychological evidence that the existence of such a choice may indeed induce procrastination. The ideal savings plan from a behavioral standpoint has strong commitment devices, not easy future alternatives that may induce procrastination. Behavioral economics suggests that sound policy to encourage early and consistent participation in a tax advantaged savings plan dictates making the costs of delay loom larger, not reducing the economic sting of procrastination. *See* TED O'DONOGHUE & MATTHEW RABIN, *Procrastination in Preparing for Retirement*, *in* BEHAVIORAL DIMENSIONS OF RETIREMENT ECONOMICS, *supra* note 2, at 151-52 (suggesting making any "catch up" alternative plan should be a non tax-advantaged plan).

204. GALLUP SURVEY, *supra* note 92, at 23 (indicating that a very large percentage of annuity purchasers mention the tax benefits as an important factor in making the decision to purchase an annuity).

205. The evidence with respect to IRAs is instructive. Starting in 1982, eligibility for deductible traditional IRAs was extended to all taxpayers. Between 1982 and 1986, the number of households contributing to a traditional IRA rose substantially. After 1986, eligibility for deductible traditional IRAs was significantly limited, and the number of households contributing to traditional IRAs fell dramatically. The increase in participation during 1982 and 1986 could have been due at least in part to strong promotional activities by the financial institutions during the period of universal eligibility for deductible IRAs. BERNHEIM, *supra* note 1, at 66.

4. *Likely Effect of Deferred Variable Annuities on Savings*

Whether targeted tax benefits increase saving is an empirical issue, and the evidence is equivocal with respect to qualified retirement plans.[206] There is some evidence that simple and easy to understand savings plans like 401(k)s, which are judged to be sound by experts, provide immediate tax benefits, strong commitment aspects like automatic payroll contributions, restrictions on withdrawals, and penalties for early withdrawals, may have a positive effect on the savings levels of individuals who lack self-control.[207] Unfortunately, deferred variable annuities are not designed with those behavioral factors in mind.

While there have been no definitive studies addressing whether savings used to purchase deferred annuities represent new savings, it is likely they do not. Many owners of nonqualified deferred annuities use proceeds from existing savings or from "one-time" events rather than new savings to buy their policies.[208] Unlike all other tax-advantaged retirement savings plans, there is no requirement that the purchaser of a nonqualified annuity have any earned income, making it much more likely that annuity purchases are funded with existing assets rather than with new savings from reduced consumption. While more than half of annuity owners use some of their current income to purchase an annuity,[209] it is not possible to determine whether these amounts would have been saved even if the annuity had not

206. BERNHEIM, *supra* note 1, at 47-80. *Compare* JAMES M. POTERBA ET AL., PERSONAL RETIREMENT SAVING PROGRAMS AND ASSET ACCUMULATION: RECONCILING THE EVIDENCE, (Nat'l Bureau of Econ. Research, Working Paper No. 5599, 1996) (suggesting a positive effect of tax incentives on savings) *with* ERIC M. ENGEN ET AL., THE EFFECTS OF TAX-BASED SAVING INCENTIVES ON SAVING AND WEALTH, (Nat'l Bureau of Econ. Research, Working Paper No. 5759, 1996) (criticizing the economic models used in studies that find a positive effect of tax incentives on savings). Furthermore, even if tax incentives do increase savings, there are no studies on whether they do so at an acceptable cost. Even if they do not increase savings at all, providing access to tax advantaged savings plans may be justified on equity grounds for certain groups who cannot take advantage of tax advantages provided to others—households that do not have employer pension coverage. ENGEN ET AL., *supra*, at 48.

207. *See* Laibson et al., *supra* note 196 (describing an economic model developed to simulate the effect of savings incentives on hyperbolic consumers (those who inordinately value instant gratification)).

208. GALLUP SURVEY, *supra* note 92, at 25-26 (indicating 55 percent of owners of nonqualified annuity contracts used existing savings to purchase the annuity). In addition, 21 percent used an inheritance, 13 percent used proceeds from the sale of a home, farm or business, thirteen percent used a death benefit from a life insurance policy, 11 percent used a gift from a relative, and 10 percent used a bonus from their employer. *Id.* at 25. However, the proportion of owners citing existing savings and proceeds of other investments as the source of funds to purchase an annuity has decreased from prior surveys. *Id:* The 1992 survey reported 62 percent of owners using existing savings and 44 percent using proceeds of other investments. *Id.*

209. *Id.* at 26.

been available.[210] As with qualified plans, since there is no tax penalty for withdrawal of funds from a deferred annuity after age 59 _, savings in deferred annuities for older individuals is a better substitute for other nonqualified saving and thus less likely to represent new savings. Annuity owners age sixty-four or over are more likely to use existing funds and less likely to use money from their current income to fund the purchase, making it even less likely that those purchases represent new savings.[211] Thus, it is highly unlikely that the deferred variable annuities have spurred any significant new savings.

C. INVESTMENT ASPECTS OF DEFERRED VARIABLE ANNUITIES

1. Introduction

Even if deferred variable annuities do not increase the level of savings, their preferred tax status might be warranted if they encourage optimal retirement investment. This section discusses the theory and evidence with respect to optimal investment.

2. Behavioral Investment Principles

Behavioral economics has one clear and unambiguous conclusion with respect to individual investment decisions: too much choice often produces less than optimal results and is not beneficial, particularly if the choices require expertise that most people do not possess. While traditional economic principles assume that an individual can never be worse off by having additional choices, one key and pervasive principle of behavioral economics is that choice is a two edged sword. While choice can provide major benefits, there are also costs associated with it.

Expanded choice can provide benefits in two ways. First, when individuals have highly differentiated tastes or needs, more choices permit

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210. While premiums paid on immediate annuities or on single premium deferred annuities do not represent new savings since they are paid with accumulated funds, premiums paid on flexible premium deferred variable annuities may represent new savings. However, the initial premium payments on such polices, which likely represent already accumulated funds, are much greater than the later payments that are more likely to represent new savings. For example, in 1995 and 1996, initial premium payments on flexible premium polices totaled $28.9 billion and $32.9 billion, respectively; while later premium payments totaled $17.7 billion and $15.5 billion, respectively. Mark J. Warshawsky, *The Market for Individual Annuities and the Reform of Social Security*, BENEFITS Q. 66 (Third Quarter 1997) at 71, tbl. I.

211. BERNHEIM, *supra* note 1, at 35. Only 44 percent of owners age 64 or over use money from their or their spouse's current income versus 64 percent for those under age 64, and 61 percent of owners age 64 and over use existing savings versus 48 percent for those under age 64. GALLUP SURVEY, *supra* note 92, at 26.

more people to satisfy their own particular wants or needs.[212] Second, even when people have similar wants or needs, more choices promote competition among providers and leads to lower prices or improved quality.[213] However, for the competitive benefits to be realized, consumers must be reasonably well informed about price and quality.[214] If consumers can be easily misled, competition might focus on marketing rather than price and quality.[215]

Expanded choices can impose three kinds of costs: time costs, error costs, and psychic costs.[216] Since time is a scarce commodity for most people, deliberation time is a cost; the more time one spends on deliberation, the less time one has for other desired pursuits.[217] Additional choices that require additional deliberation time impose additional cost, often including psychic costs, such as anxiety over not devoting sufficient time to complex tasks or over having to neglect other tasks in order to devote sufficient time to the more complex tasks.[218] Expert advice is not always a viable alternative because experts are prone to be overconfident, particularly when dealing with complex and uncertain matters.[219] Furthermore, if the task is complex, as retirement savings and investment decisions often are, then judging the qualification of the experts will be difficult and costly, the advice itself likely will be costly and there may be no agreement among the experts, necessitating further costly deliberation over which expert advice to accept.[220]

Error costs result from a variety of factors. If there are too many choices, an individual may suffer from decision-overload; as the number of choices expands, people consider a progressively smaller number of them,

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212. *See* Loewenstein, *supra* note 130, at 1. The brief discusses the pros and cons of permitting more choice within the Social Security system and provides an excellent discussion of the benefits and costs of more choice in general. *Id.* at 1-6.

213. *Id.* at 1.

214. *Id.*

215. *Id.* at 1-2.

216. *Id.* at 2.

217. *Id.*; *see also* John Conlisk, *Why Bounded Rationality,* 34 J. OF ECON. LITERATURE 669 (1996) (arguing that deliberation costs may be one reason why individuals do not always solve the difficult mathematical problems that economists assume they do to maximize utility but rather develop less costly rules of thumb that only approximate optimal behavior).

218. Loewenstein, *supra* note 130, at 2 (citing the specific example of anxiety over not having devoted enough time to financial planning).

219. Rabin, *supra* note 197, at 32. The illustrations given include the likely movement of the stock market, which cannot be reliably predicted from present data. *Id.* Expert analysts who have developed elaborate models to predict the future course of the market are more likely to be confident of their predictions than are nonexperts. *Id.* The fact that experts are able to articulate reasons for their predictions tends to increase their level of confidence in their judgments, even though their judgments are in fact no more accurate than those of nonexperts. *Id.*

220. Loewenstein, *supra* note 130, at 2.

and as decisions become more complex, people use simpler decision rules, such as choosing the cheapest or the most expensive.[221] In addition, as decisions become more difficult, people may respond to additional choices by procrastinating[222] or by adopting a rule that requires no decision among the available choices.[223] For example, when given choices of investment options, people may merely allocate their savings ratably over all options.[224] These problems are exacerbated for those who lack self-control and are even more driven by short-term costs than future benefits.[225]

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221. *Id.*

222. *Id.* A person who procrastinates due to an inordinate preference for immediate gratification may put off investigating or implementing superior investment choices. O'DONOGHUE & RABIN, *supra* note 203, at 125. Introducing more options to a person who would not otherwise procrastinate can actually induce procrastination that would not otherwise occur. Given a small number of easy to understand choices, a person may have no difficulty choosing the optimal one. The addition of more choices, particularly if they are more difficult to assess, increases the deliberation costs of making an optimal decision. If the individual perceives one or more of those additional choices as possibly superior, but is currently unwilling or unable to invest the resources to make the determination of which is optimal, he or she may do nothing. In a sense, the better is the enemy of the good: given one other good choice, he or she might well move savings. TED O'DONOGHUE & MATTHEW RABIN, CHOICE AND PROCRASTINATION 18 (Institute of Business and Economic Research, University of California-Berkley, Economics Dep't Working Paper No. EOO-281, April 25, 2000).

223. Loewenstein, *supra* note 130, at 2.

224. GREED & FEAR, *supra* note 175, at 135-36 (citing Shlomo Benartzi & Richard Thaler, *Naïve Diversification Strategies in Defined Contribution Savings Plans*, 91 AM. ECON. R. 79 (2001)); *see also* JAMES J. CHOI ET AL., DEFINED CONTRIBUTION PLANS: PLAN RULES, PARTICIPANT DECISIONS, AND THE PATH OF LEAST RESISTANCE 26-27 (Nat'l Bureau of Econ. Research, Working Paper No. 8655, at 26-27, 2001). Using a database of 170 retirement plans, they found that approximately 62 percent of the funds offered in the plans were equity funds, and the fraction of total assets held in equity funds was very close to 62 percent. *Id.* They also found a positive relationship at the plan level between the fraction of equity funds offered by the plan and the fraction of individual portfolios invested in equities. *Id.*

225. Loewenstein, *supra* note 130, at 2-3. Psychologists have modeled the self-control issue in various ways. Some propose a model that treats an individual as two selves: a patient planner and an impatient doer. Thaler & Shefrin, *supra* note 172, at 392. Others posit that self-control problems in some contexts arise from time-inconsistent preferences, termed "hyperbolic discounting." Laibson et al., *supra* note 196, at 97. This model can be derived from the Thaler-Shefrin model by assuming that the "planner" and the "doer" strike an efficient bargain in every period. BERNHEIM, *supra* note 1 at 39; *see also* Ainslie, *supra* note 197; R.H. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization*, 23(3) R. OF ECON. STUDIES 165 (1955-56). It is not clear how much of the population is prone to hyperbolic discounting, but behavioral scientists believe it is a significant number. The evidence supports a finding of varying degrees of hyperbolic discounting in a very large number of test subjects. *See* Ainslie, *supra* note 197, at 335; *see also* Strotz, *supra*, at 177 (stating that most of us are "born" with hyperbolic discount rate functions). There is also some evidence that the phenomenon may be bred in us by nature since it has also been observed in other animals *See* Ainslie, *supra* note 197, at 334 (citing studies on animals choosing between two amounts of food at different delays). To further complicate the analysis, some people are aware of the problem while others may not be. *See* Rabin, *supra* note 197, at 40. Those aware of the problem are called sophisticated and those unaware are called naïve. *Id.* It is generally assumed that most people are at least partially naïve. *Id.*

Lack of self-control makes retirement savings more difficult because it causes an individual to especially value current consumption over future consumption. It is one of the prime reasons people procrastinate in starting a retirement savings plan. *See generally* O'DONOGHUE & RABIN,

Error may also result from loss aversion[226] or, at the opposite extreme, overconfidence.[227] In particular, investors under the age of 55 seem to have an overly optimistic view of likely investment returns over the next ten years, and many investors are convinced they can time the stock market even though those who trade the most realize the worst performance.[228]

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supra note 222 (discussing the general problem of procrastination). Procrastination may also affect how wisely a person who does save invests savings. *See* O'DONOGHUE & RABIN, *supra* note 203.

226. Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. OF ECON. PERSP. 193 (1991). Loss aversion describes the phenomenon that losses have a larger psychological impact on individuals than gains. *Id.* For small or moderate gains and losses of money, the ratio is about 2 to 1; a loss causes twice as much psychological pain as the psychological pleasure provided by an equal gain. *Id.* Loss aversion affects savings decisions because once a household gets used to a particular level of consumption, they tend to view reductions in that level as a loss. Thaler & Benartzi, *supra* note 189.

In addition to making saving difficult, loss aversion also affects investment decisions in a number of ways. Individuals have great difficulty coming to terms with investment losses. They are very reluctant to admit they have made an investment mistake, sell the investment at a loss, and move on. GREED & FEAR, *supra* note 175, at Chapter 9: "Get-Evenitis": Riding Losers Too Long. They also have a tendency to sell investments in which they have a gain too early. *See* Hersh Shefrin & Meir Statman, *The Disposition to Sell Winners Too Early and Ride Losers Too Long*, 40 J. OF FIN. 777, 782 (1985) (suggesting that the quest for pride leads to the disposition to realize gains, but that anticipated regret may also cause investors to be reluctant to realize gains; if they monitor the stock sold and it rises in value, they will regret having sold it, and therefore if regret is much stronger than pride, inaction may be preferred over action for gains as well as losses).

Loss aversion coupled with a short planning horizon, myopic loss aversion, can result in the choice of a less than optimal portfolio allocation. In making investment decisions under uncertainty, individuals tend to be too conservative in their allocations to risky assets such as stocks when they focus on likely short rather than long-term results. For example, when shown the likely one year results from stock investments, indicating about a one-third chance of under-performing bonds, they evidence less willingness to invest in stocks than when shown likely thirty-year stock results, indicating about a five percent chance of under-performing bonds. Shlomo Benartzi & Richard H. Thaler, *Risk Aversion or Myopia: Choices in Repeated Gambles and Retirement Investments*, 45 MANAGEMENT SCIENCE 364 (1999); *see also* Shlomo Benartzi & Richard H. Thaler, *Myopic Loss Aversion and the Equity Premium Puzzle*, 110(1) Q. J. OF ECON. 73 (1995) (discussing the equity premium and arguing that it is a function of the planning horizon of investors); Daniel Read et al., *Choice Bracketing*, 19 J. OF RISK & UNCERTAINTY 171 (1999) (discussing investors' tendency to make risky decisions one at a time instead of taking a portfolio perspective that puts each risk in a lifetime perspective).

227. GREED & FEAR, *supra* note 175, at 131-33. Individual investors are overconfident and overly optimistic about the probable future performance of investments they own. *Id.* (citing a 1998 survey of individual investors).

228. Loewenstein, *supra* note 130, at 3; GREED & FEAR, *supra* note 175, at 134-36 (citing BARBARA O'NEILL, HOW PEOPLE HANDLE THEIR MONEY (1990)). A recent study conducted by the Financial Research Corporation found a growing tendency by mutual fund investors, particularly those that do not use an advisor, to trade too frequently and to make unwise timing decisions. *INVESTORS BEHAVING BADLY, AN ANALYSIS OF INVESTOR TRADING PATTERNS IN MUTUAL, FUNDS* FINANCIAL RESEARCH CORPORATION 2002. Another study by the financial services firm Dalbar, Inc. looked at mutual fund performance during seventeen years and concluded that while the average stock fund gained an average 14 percent per year (an the S&P 500 gained an average 16.3 percent), the typical mutual fund investor gained only an average 5.3 percent, largely due to buying the wrong funds at the wrong time by consistently seeking out the hot funds, the best performers from the previous year. MORE PROOF THAT MARKET TIMING

Although individuals seem to understand the stock market better today than they used to, in many cases the understanding is superficial and does not seem to have made them better investors. Instead, because they think they are better investors, they have less fear, take undue risks, gamble, speculate, and often lose. Error also results from status quo bias,[229] failure to consider inflation,[230] and bias toward familiar investments.[231]

The psychological costs of additional choice include anxiety and regret. Anxiety occurs when a decision requires expertise the person does not have or requires difficult trade offs, such as choices between investment options that are safe but offer a low and relatively certain rate of return and ones that are riskier but offer a higher but uncertain expected return.[232]

Regret occurs when a person's choice turns out badly. It is the sense of feeling responsibility for a loss.[233] The more choices a person has, the more

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DOESN'T WORK FOR THE MAJORITY OF INVESTORS, UPDATE, DALBAR, (June 21, 2001) (*available at* http://www.profisys.com/dalbar.htm) (last visited Dec. 1, 2003).

229. Kahneman et al., *supra* note 217, at 197-98. Status quo bias or inertia is the strong tendency of individuals to remain at the status quo. It is thought to result from loss aversion, for the disadvantages of deviating from the status quo loom larger than the advantages. *Id.*

230. GREED & FEAR, *supra* note 175, at 31-32. While individuals are capable of adjusting for inflation, it is not the natural way most of us think. *Id.* (citing Eldan Shafir et al., *Money Illusion*, 112 Q. J. OF ECON. 341 (1997)). For example, most people would not consider themselves as losing money if they invested $10,000 in a stock that was still worth $10,000 one year later. Since inflation has eroded the buying power of the $10,000, there has been an economic loss, but since most people consider only the nominal value of money, they tend to ignore the effects of inflation. Over very long periods of time, inflation can seriously erode buying power, so ignoring inflation when making investment decisions will result in less than optimal portfolio choices.

231. Investors have a bias toward investing in stocks of companies based in one's own country, which may be due to what is called the home bias: in unfamiliar situations, we tend to concentrate on what we are familiar with, even though that may be risky and is not optimal investment behavior. GREED & FEAR, *supra* note 175, at 136. It appears that if the employer's stock is one of the investment choices, participants put a large fraction of their contributions into the employer's stock even if they are not required to. *See* Sarah Holden et al., *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 1998*, 6(1) PERSPECTIVE (Investment Company Institute, Washington, D.C.), Jan. 2000, at 9 (finding that for firms that offer company stock as an option, 33 percent of plan assets are held in company stock); *see also* NELLIE LIANG & SCOTT J. WEISBENNER, INVESTOR BEHAVIOR AND THE PURCHASE OF COMPANY STOCK IN 401(K) PLANS – THE IMPORTANCE OF PLAN DESIGN, (Nat'l Bureau of Econ. Research, Working Paper No. 9131, 2002) (concluding that the number of investment alternatives offered and whether the company requires some of the match to be in company stock are key factors of the share of total contributions in company stock, that participants do not offset an employer match in company stock with a smaller share of their own contributions to company stock, and that workers appear to view other plan restrictions as providing cues about the desirability of purchasing company stock). This bias toward company stock may be a form of home bias. GREED & FEAR, *supra* note 175, at 136.

232. Loewenstein, *supra* note 130, at 3.

233. GREED & FEAR, *supra* note 175, at 30. The simplest and most effective way to avoid regret is to relinquish freedom of choice, for without choice there can be no regret about having made poor choices. The current Social Security system and traditional defined benefit retirement plans are typical examples of retirement savings plans that provide little if any choice. A way to lessen but not eliminate the possibility of regret without eliminating choice is to take action based

possibility there is for bad outcomes and regret. Feelings of regret are an important source of personal misery.[234]

Expanded choice is not beneficial when it requires expertise people don't possess since in that case, the benefits from competition are likely minimal, required deliberation time for optimal choice is likely to be substantial, people are more likely to make bad decisions, and the decision making process is likely to be a considerable source of anxiety and anticipated regret.[235]

Under the Life Cycle Hypothesis (LCH) and under modern portfolio theory,[236] an individual must solve complex mathematical problems to determine optimal savings and investment strategies, yet most of the United States population is not able to make even basic economic calculations.[237]

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on the advice of experts rather than based on one's own analysis: if the investment turns out badly, the advisor can be blamed. *Id.* at 129-30; *see also* Hersh Shefrin & Meir Statman, *How Not to Make Money in the Stock Market*, PSYCHOLOGY TODAY 52, Feb. 1986.

234. Loewenstein, *supra* note 130, at 3. Remarkably, Harry Markowitz, the Nobel Laureate recognized for having developed modern portfolio theory, did not choose the most efficient retirement investment portfolio called for by his theory, but he rather chose a less aggressive one so as "to minimize my future regret." GREED & FEAR, *supra* note 175, at 31.

235. Loewenstein, *supra* note 130, at 3-4.

236. Modern Portfolio Theory (MPT), a broad theory of portfolio selection and corporate finance, explains how risk-averse investors should structure their portfolios to optimize expected returns taking into account market risks. Harry Markowitz introduced it in a paper in the 1952 Journal of Finance. Harry Markowitz, *Portfolio Selection* VII J. OF FIN. 77 (1952); *see also* Harry M. Markowitz, *Foundations of Portfolio Theory*, 46 J. OF FIN. 469 (1991). In 1990, he shared a Nobel Prize with Merton Miller and William Sharpe for what developed into a broad theory of portfolio selection and corporate finance. The theory explains how risk-averse individuals should construct investment portfolios to optimize expected returns for desired levels of market risk. Out of a universe of risky assets, an efficient frontier of optimal portfolios is constructed that offer the maximum expected return for given levels of risk. *See* PETER L. BERNSTEIN, CAPITAL IDEAS (Free Press Reprint Ed. 1993) (discussing the history of MPT).

Many individuals do not seem to assemble the investment portfolios predicted by standard economic theory but rather ones they find more attractive for psychological reasons. *See* GREED & FEAR, *supra* note 175, at Chapter 10, "Portfolios, Pyramids, Emotions and Biases;" *see also* Hersh Shefrin & Meir Statman, *Behavioral Portfolio Theory*, 35 J. OF FIN. & QUANTITATIVE ANALYSIS 127 (2000). They prefer portfolios that are a combination of very conservative and very risky components, reflecting a philosophy of absolute safety first before investing for potential. GREED & FEAR, *supra* note 175, at 126. The optimal security design for such an investor consists of a combination of secure bonds and lottery tickets. Such a security is available in Great Britain and in Sweden, both of which issue lottery bonds. Shefrin & Statman, *supra*, at 148. Lottery bonds are bonds issued by the government that pay no interest but rather give the holders lottery tickets in place of interest coupons. *Id.* In this country, a variety of securities have been developed to provide security with some upside potential. GREED & FEAR, *supra* note 175, at 127-28 n.11.

237. BERNHEIM *supra* note 1, at 37; *see also* B. DOUGLAS BERNHEIM & DANIEL M. GARRETT, THE DETERMINANT OF CONSEQUENCES OF FINANCIAL EDUCATION IN THE WORKPLACE: EVIDENCE FROM A SURVEY OF EMPLOYERS, (Nat'l Bureau of Econ. Research, Working Paper No. 5667, 1996) (finding that financial illiteracy is correlated with under preparation for retirement). This is the issue generally referred to as "bounded rationality." The standard life cycle hypothesis assumes that an individual has unlimited mental faculties and is able to formulate and solve even very difficult problems using sophisticated mathematical techniques.

Thus, there is some doubt whether the typical person can even formulate a reasonable plan, let alone execute it.

Experience, expertise, and learning can moderate the effect of biases and lack of knowledge, but the research does not strongly support the assumptions made by many economists that real world learning experiences substantially eliminate biases in nonexperts.[238] While many people do learn general principles, they still do not accurately apply those principles in individual cases.[239] In general, the conditions that best promote learning are rewards, small deliberation costs, good feedback, unchanging circumstances, and simple context,[240] which are not present with respect to long-term retirement investment decisions.[241]

Relying on the advice of experts may not be a satisfactory alternative. Much of the advice provided by third parties is often not very sophisticated, consisting of crude rules of thumb that may not be very useful. Psychologists have documented that people tend to rely on rules of thumb to make complex tasks simpler, and that while such rules are often quite useful, sometimes they lead to severe and systematic errors caused by biases in judgment.[242] There is evidence that experts are more prone to overconfidence than laypersons.[243]

See John Conlisk, *Why Bounded Rationality*, 34 J. OF ECON. LITERATURE 669 (1996) (discussing and criticizing that assumption and an argument for incorporating bounded rationality into economic models).

238. Rabin, *supra* note 197, at 31.

239. *Id.* Such people may even see their errors when confronted with them yet continue to make the same errors in the future. *Id.* Surprisingly, learning or expertise can sometimes actually exacerbate judgment errors. When dealing with highly predictable possibilities, experts' opinions tend to be very accurate. However, as previously noted, when predictability is low, which is when accurate guidance is most important, experts are often even more susceptible to overconfidence than laypersons. *See supra* note 219 and accompanying text.

240. Conlisk, *supra* note 237, at 683.

241. BERNHEIM, *supra* note 1, at 37. Individuals retire only once; they do not have frequent opportunities to observe the retirement decisions and results of those decisions made by others. Unsophisticated individuals may not recognize the need for expert advice or have the ability to evaluate its quality if they get it. *Id.*

242. Rabin, *supra* note 197, at 24. Such errors include exaggerating how closely a small sample will resemble the larger population from which it is drawn, becoming wedded to an existing hypothesis, and ignoring or misinterpreting or misreading new information contradicting their hypothesis. *Id.* at 24-29.

243. *Id.* at 32. As previously noted, a recent study examined the advice given by professional financial planners concerning what withdrawal rate from an accumulated investment portfolio should be recommended during the retirement years, consistent with making the cash flows last as long as possible. Ameriks et al., *supra* note 14. Using Monte Carlo simulations of the likely outcomes of the advice given by various experts, the study concluded that clients who followed the advice were at substantial risk of outliving their assets. *Id.* at 60-61. This means that the experts were likely giving incorrect advice to their clients during their non-retirement years concerning what level of accumulated assets they needed at retirement. *Id.* at 60.

3. *Investment Choices in Deferred Variable Annuities*

The typical deferred variable annuity, which offers fifteen to thirty investment subaccounts to choose among, does not differ significantly from a family of mutual funds. The equity funds run the gamut from broadly diversified funds to funds that focus on a particular industry or market sector. Both the SEC and the NASD have cautioned that the product may be an unsuitable investment for many individuals because of the complexity of the investment choices.[244]

Those approaching retirement age with insufficient assets are of particular concern. Many of those households probably arrived there for reasons related to inability to plan and lack of investment expertise. Left to their own devices they might either invest too conservatively or, at the other extreme, take unreasonable risks by failing to adequately diversify, overestimating their own expertise or trying to time the market to enhance returns. The generous array of investment choices available in the typical deferred variable annuity makes such potentially costly actions much more likely. Unfortunately, such errors will be particularly costly for those households because they do not have sufficient time to recover from them. The only nonqualified, tax-advantaged retirement savings plan is unsuitable for those who probably need it the most.

It is also not likely that the unsophisticated will heed the SEC's and the NASD's warnings that deferred variable annuities are unsuitable for unsophisticated investors. The government has bestowed its imprimatur on them by making them tax-advantaged, and that is likely to outweigh the effect of any precautionary statements about suitability that may or may not be stressed by brokers or financial planners making a living selling the product.

Behavioral biases make investment decisions difficult for many individuals, particularly those who are unsophisticated and lack self-control. Their behavior is often at odds with the predictions of standard economic theory and therefore is not likely to be affected by standard economic incentives. However, behavioral prescriptions may be effective and less costly.

Since the United States economic system is largely based on free choice, it is hard to justify using governmental incentives merely to alter individual preferences, and it is not clear that incentives are at all effective in doing so. If an individual invests unwisely because of some remediable behavioral problem, such as behavioral biases compounded by bounded

244. *See supra* notes 179-80 and accompanying text.

rationality and lack of self-control, then governmental policies aimed at remedying these deficiencies, even if they restrict free choice, are not contrary to laissez faire economic principles, and they also have a greater chance of being effective.[245]

While investors seem to require some degree of choice before they are willing to commit to a plan, too much choice in the hands of unsophisticated investors can result in very costly mistakes, a reality that should be taken into account in designing any tax advantaged savings plan. Whatever gains that investors may obtain from choosing their own investment portfolios is likely to be maximized with a small number of carefully selected alternatives.[246]

D. SUMMARY

The likely behavioral savings and investment effects of nonqualified deferred variable annuities are weak and in many cases actually counterproductive. They are not designed to encourage early savings or even systematic savings plans. They are very attractive to those who have already accumulated funds and are seeking a tax-advantaged vehicle for them, and the available data strongly suggests that is one of the most important reasons a large majority of policyholders purchase them.

The typical product is not simple, easy to understand, and judged desirable by most experts. Because of its complexity, it is not suitable for a large number of individuals with varying degrees of sophistication. It is not designed to be particularly useful to the households most in need of additional retirement savings—those that find themselves close to retirement age without having accumulated sufficient assets. Those households need serious assistance and cannot afford to make any costly investment mistakes since they have so little time to recover from them. The typical deferred variable annuity, with its broad array of investment fund options, provides too little guidance and too much chance to make ill-advised, costly errors. By themselves, the savings and investment aspects of variable annuities provide no compelling reasons to accord them the special tax status they have.

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245. O'Donoghue & Rabin, *supra* note 203. The authors concluded: "We believe that most people are most of the time better judges of what is good for them than are government officials, economic theorists, and other social scientists.... But we also believe that people often make errors, that there is some discernible pattern to these errors, and that people sometimes cause significant harm to themselves by making these errors." *Id.* at 26.

246. *See* Shlomo Benartzi & Richard H. Thaler, How Much is Investor Autonomy Worth? (unpublished manuscript) (*available at* www.anderson.ucla.edu/faculty/shlomo.benartzi/autonomy.pdf) (last visited Dec. 1, 2003).

V. POLICY PRESCRIPTIONS

A. INTRODUCTION

Since neither the savings and investment aspects nor the annuitization aspects of deferred variable annuities as they are currently designed provide any persuasive policy reason to grant them the special tax status they have, there are two plausible responses: treat them like regular taxable mutual funds during the accumulation phase or search for a more rational design of the product that would justify granting them preferred tax status.

B. CAN A MORE RATIONAL DEFERRED VARIABLE ANNUITY BE DESIGNED?

1. Introduction

The threshold policy issue is whether any product should be granted the special tax benefits currently accorded to deferred variable annuities during the accumulation phase. A recent GAO report concludes that such benefits are unwarranted because they provide benefits mainly for middle and upper-income individuals; while low income people receive their benefit largely through the Social Security system.[247] While the "tax shelter" aspect of deferred variable annuities is the usual criticism advanced by those who oppose their special tax status, an even more troubling factor is that because of their many tax and non-tax disadvantages, they are simply not a very good investment vehicle, despite their tax sheltering potential. They are being inappropriately marketed to such purchasers with considerable success. Unless the product can be redesigned in such a way that it is simpler and more suitable for large numbers of individuals with varying degrees of sophistication, is judged to be a sound program by most experts, is unlikely to be purchased by someone who values only its tax shelter possibilities, is difficult to inappropriately market to purchasers for whom it is an unsuitable investment, and will be more likely to be annuitized, then the conclusion reached in the GAO report is correct.

The rest of this section discusses possible policy prescriptions for such a redesign. The proposals are of two kinds: those designed to enhance the

247. U.S. GEN. ACCOUNTING OFFICE, SUPPORTING CONGRESSIONAL OVERSIGHT: BUDGETARY IMPLICATIONS OF SELECTED GAO WORK FOR FISCAL YEAR 2003 (GAO-02-576, 2002). The same proposal was included in a 1990 report. *See* ACCOUNTING OFFICE, TAX POLICY: TAX TREATMENT OF LIFE INSURANCE AND ANNUITY ACCRUED INTEREST (GDD-90-31, 1990).

annuitization aspects of the product and those designed to enhance the savings and investment aspects of the product.

2. *Enhancing the Annuitization Aspects*

a. Mandatory Annuitization

The clearest way to distinguish deferred variable annuities from other investment products and to enhance their annuity aspects is to require that purchasers commit to annuitize when they purchase the annuity. In fact, if the resistance to voluntary annuitization is not primarily economic but rather because the complexity and psychological difficulty of the annuitization decision are insuperable hurdles to free choice, then the only alternative may be to require at least some level of annuitization.[248] Mandatory annuitization might also have the beneficial side effect of reducing the adverse selection problem. Requiring purchasers to commit to annuitization when purchasing a deferred annuity would not permit them to wait until they gained more information about their longevity prospects, which would tend to make the pool of annuitants more heterogeneous and less self-selected.[249]

Mandatory annuitization also has negative effects. It would be harmful to those in poor health or who otherwise can accurately predict a lowered life expectancy; it would potentially be administratively burdensome to enforce, and it is likely to be politically unpopular in this country because it severely restricts individual choice.[250] While utilizing life contingent annuitization with a guaranteed payout period, joint and survivor annuities, and front loaded annuity payments could substantially mitigate the possible harmful effects of mandatory annuitization, the administrative and political problems would still be substantial. Furthermore, mandatory annuitization can have undesirable distributional consequences. It would entail wealth transfers from those with lower life expectancies to those with higher life expectancies—from African Americans to Whites and Hispanics, from the

248. BROWN & WARSHAWSKY, *supra* note 19, at 37-38.

249. *Id.* at 38.

250. *Id.* The authors discussed the recent policy discussion in the United Kingdom, which is considering softening its current requirements that those with personal or occupational pension plans annuitize 75 percent of their accumulations by age seventy-five. *Id.* The new proposals would allow a participant to annuitize only to the extent necessary to reasonably insure that income would be sufficient to be above the level of eligibility for state welfare support. *Id.* at 38-39.

less educated to the more highly educated, and from the less wealthy to the more wealthy.[251]

A requirement that a purchaser commit to some level of annuitization when the annuity is purchased would also make the deferred annuity particularly unattractive for younger purchasers who face more uncertainty about their life expectancy, and the reluctance would be even greater for those in groups with statistically lower than average life expectancies.[252] One possibility to encourage annuitization without mandating it is to require less conservative mortality guarantees, which would make annuitization more economically attractive to individuals with average life expectancies. Less conservative guarantees would require higher mortality expenses and would no doubt deter some purchasers, but if those deterred were the individuals primarily seeking only a tax-sheltered investment vehicle and not an annuity, that would be desirable.

Unfortunately, such a feature would probably also deter some legitimate annuity purchasers. In particular, it would be very unattractive to younger individuals legitimately desiring to begin a consistent, long-term supplemental savings plan for retirement but who face significant uncertainties concerning their future health prospects and likely longevity. Forcing them to pay large insurance charges for benefits that may turn out not to be valuable to them will likely induce them to avoid the product. [253]

An attractive compromise is to require a commitment to at least partial annuitization if the deferred annuity is purchased after a certain age, for instance after age 59 _, the point at which under current tax law, the possible tax penalties on withdrawals cease. A mandatory annuitization requirement for those purchasers would discourage those who do not intend to utilize the annuity payout aspects of the annuity, for whom it is very likely an unsuitable investment, from purchasing it. Once the tax penalty no longer applies, the deferred variable annuity appears to be a closer substitute for other taxable investments, such as mutual funds. There is evidence that deferred annuities are being marketed to seniors as tax-

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251. JEFFREY R. BROWN, CTR FOR RETIREMENT RESEARCH AT BOSTON COLLEGE, HOW SHOULD WE INSURE LONGEVITY RISK IN PENSIONS AND SOCIAL SECURITY? (August 2000).

252. It would also not be a simple matter to determine the optimal age at which to require annuitization. Due to the high costs of annuities, optimal economic behavior may well be to postpone the decision whether to purchase a life contingent annuity at least until about age seventy, perhaps even longer. *See supra* Part III. Requiring an early commitment to annuitization would likely deter even purchasers who do value the annuity aspects of the product.

253. It is also unclear how such a legislatively mandated level of payout mortality guarantees would be formulated and, equally important, updated in a timely manner as new actuarial information on longevity becomes available. There is little to counsel optimism about the likely results of government action that attempts to mandate the mortality charges on a complex insurance product like annuities.

advantaged mutual funds, and the factors that make them unsuitable for investors who do not value their annuity aspects are completely ignored or downplayed. Since the break-even point for variable annuities as opposed to other investments is at least ten years, perhaps even much longer, they are particularly unsuitable for older individuals who buy them as substitutes for other investments since there is a higher probability they will not survive until the break-even point. A requirement of mandatory annuitization for older purchasers would be an effective way to end such abusive sales practices. The purchase age at which a mandate of annuitization should be imposed is a policy determination, but it should apply at some age. For example, is there any legitimate reason why a person aged seventy-five should be allowed to purchase a deferred variable annuity without committing to some level of annuitization?[254]

b. Encouraging Annuitization by Lowering Costs and Changing Perceptions

If the problem underlying resistance to voluntary annuitization is pricing of annuities, then policies designed to reduce the cost of annuities may be appropriate.[255] A number of alternatives have been suggested. The establishment of a plan like the Federal TSP program could lower transaction and search costs and could underwrite product research and innovation to encourage annuitization, reducing adverse selection. However, this might be seen as unfair competition to insurance companies that are well run and provide low cost annuities to the public.[256]

One researcher, writing in the context of Social Security reform, suggested the possibility of creating a federal board of overseers of annuity providers as well as a national clearinghouse for commercially sold annuities so that annuities from competing insurers could be offered in a clear and rational manner.[257] While such a proposal has some merit, the

254. BROWN & WARSHAWSKY, *supra* note 19, at 38-39. Even if mandatory annuitization is rejected, at the very least, annuitization should be required to be the default option in a deferred variable annuity. *Id.* Psychological research indicates that inertia and status quo bias may be sufficient to increase annutization rates merely by encouraging annuitization by making it the default option. *Id.* However, most current deferred variable annuities provide for life annuities at age sixty-five, and that has not been effective. The resistance to voluntary annuitization seems strong enough to overcome even inertia and status quo bias.

255. *Id.* at 37.

256. *Id.* at 42.

257. *See* Mark J. Warshawsky, *The Market for Individual Annuities and the Reform of Social Security*, BENEFITS Q. 66, 75-76 (Fourth Quarter 2001) (suggesting that this would deal with solvency and fraud as well as obviate the need for commissioned agents and brokers, thereby lowering overall expenses and reducing the wide spread in annuity payouts that currently exists in the private market).

cost and administrative burdens of creating an additional governmental bureaucracy would be substantial, and the likely political resistance to such a proposal is obvious. Furthermore, given the vast array and complexity of deferred variable annuities currently being marketed, it isn't clear what a federal board or national clearinghouse could accomplish. Only in conjunction with simplification and rationalization of the design of deferred variable annuities would such a proposal be at all feasible. The optimal prescription would be to simplify the design of the product enough to diminish the need for such a board or clearinghouse.

One intriguing possibility for lowering costs and changing perceptions about annuitization is to permit a true risk pooling of annuitants, like the current CREF retirement annuity for qualified plans, which provides no mortality guarantees in either the accumulation or payout phase. Annuity payments vary with both investment and mortality experience. While the annuitant does bear some mortality risk, that risk is minimized through risk pooling. Each annuitant is still promised annuity payments for life, but the mortality experience of the annuitant pool will affect the level of the annuity payments. With a large enough annuity pool and reasonable mortality assumptions used to compute initial annuity payments, mortality experience is not likely to differ greatly from the mortality assumptions used to compute the initial payments, and any changes will occur very slowly.

The CREF retirement variable annuity has been operating since 1952 in its stock account with no discernible problems. Because mortality assumptions used to compute the initial annuity payments are not guaranteed, the initial payments under the CREF variable annuity backed by the stock account are computed somewhat less conservatively than those used for the guaranteed annuities issued by TIAA. The actuaries can be less conservative in their initial mortality assumptions because errors may be corrected by future adjustments in annuity payout levels. The CREF annuity payments based on the stock account have tended to work slightly lower over time due to actual mortality experience because the actuaries were not conservative enough in their initial assumptions. However, the decreases have been very small.[258]

One extremely beneficial aspect of actually pooling the annuity mortality risk is that it eliminates the perception that the insurance company is betting against an individual's longevity and will benefit if the mortality

258. I obtained this information in informal communications with researchers at the TIAA-CREF Institute, who informed me that they are currently working on an "Issue Brief" discussing the pros and cons of such a fully participating variable annuity.

experience of the pool is greater than was assumed in pricing the annuity. Any benefits of mortality experience will flow through to the survivors in the pool, who will receive greater future annuity payments, and not go to the insurance company.[259] Each survivor in the annuity pool would be assured of receiving the correct "mortality premium" for having taken the risk of purchasing a life contingent annuity, making the product potentially more attractive. To be effective, the annuity pool would have to be large enough to assure sufficient risk pooling and avoid too much year-to-year variance in annuity payments due to mortality experience. Given the current thin market for voluntary annuitization in the United States, that might require pooling annuitants across a number of separate companies or the utilization of one common annuity pool for all deferred variable annuity contracts in the payout phase.

Because no mortality guarantees are provided, there would be no mortality charges during the accumulation phase or the payout phase, making the product more attractive. The current weak mortality guarantees provided on deferred variable annuities, which add to both the cost and complexity of the product, could be eliminated.[260] Eliminating mortality guarantees would also eliminate one of the disincentives to encouraging annuitization that insurance companies now have—the losses they may incur if their annuity mortality tables turn out to be inaccurate.

This proposal is attractive because it would lower the costs of the deferred variable annuity and decrease its complexity, making it easier to sell. This proposal is important because it would address one of the primary psychological barriers to voluntary annuitization, the perception that the insurance company is betting against the annuitant's longevity and stands to gain from his or her early demise. The primary downside of such an annuity is that it does not provide true insurance against longevity in the sense of guaranteed payout rates. However, the experience of the TIAA-CREF retirement annuity indicates that lack of insurance is not likely to be

259. In my informal contacts with researchers at the TIAA-CREF Institute concerning this issue, I was informed that this recently occurred with respect to the CREF retirement annuity backed by one of its newer funds, the inflation linked bond fund. A wealthy annuitant in that fund passed away very early and because his payments were a substantial portion of the total annuity payments being made from that fund, his early demise resulted in the other annuitants in that pool getting an increase of approximately 10 percent in their annuity payment levels. Had this been a guaranteed annuity, the other participants would not have shared that mortality gain, which would have gone instead to the insurer.

260. Even if it is determined that a payout annuity without mortality guarantees is not viable, there is no reason why there must be mortality payout guarantees during the accumulation period. Given the fact that they are so extremely weak that it is never intended that they will be used, they seem only to add to the complexity and cost of the product.

a substantial economic factor if a sufficiently large and diverse annuity pool could be formed.[261]

While such an annuity might be attractive, it would be a significant departure from current mainstream annuity design. It would also require tax legislation because such a product would probably not be treated as a tax-advantaged, nonqualified deferred annuity under current law since it lacks any insurance guarantees. Furthermore, if there were no mortality guarantee charges during the accumulation phase and there were no requirement of annuitization, it would be even more likely that people would purchase it primarily or solely as a substitute for other retirement investment options and not for its annuity aspects. Thus, this option would only be appropriate in conjunction with other policy prescriptions that served to reasonably insure that the product was not being purchased primarily for its tax deferral benefits.

c. Use of Penalty Provisions to Encourage Annuitization

Another way to encourage annuitization without mandating it is to penalize any distributions that are not in the form of annuities.[262] Currently, there are penalties for early withdrawals from nonqualified annuities, but they only apply to distributions before age 59 _. After that age, there is no penalty, even for cashing the policy in and taking a single lump sum payment. The penalty provisions for deferred variable annuities should be designed to insure not only that the amounts accumulated are used for retirement purposes, but also that they are used to provide a retirement annuity. Therefore, unlike the penalty provisions applicable to qualified retirement plans, the only function of which is to insure that the funds are used in some way for retirement purposes, the penalty provisions for deferred variable annuities should extend to all ages.[263] Extending the penalty would also clearly differentiate deferred annuities from other investments for senior citizens to whom they are routinely being marketed

261. To prevent extreme fluctuations, a possible middle ground would provide doomsday insurance that would be effective if the mortality experience of the annuity pool improved too dramatically.

262. BROWN & WARSHAWSKY, *supra* note 19, at 42 n.21.

263. If the penalty were extended to later ages, then an exception should be provided for distributions to pay extraordinary medical expenses, including long-term care expenses. Such an exception is currently provided for distributions from qualified plans. I.R.C. § 72(t)(2)(B) (2002). Extending the penalty would not have the same potential adverse effects on policyholders who are in poor health that mandatory life annuitization would have. To avoid the penalty, the policyholders need only take distributions in the form of a fixed period annuity over their life expectancy. *See supra* note 56.

as alternatives to other taxable investments, even though they are often unsuitable investments for them.

Extending the penalty would also strengthen the commitment aspects of the deferred annuity by discouraging distribution patterns not designed to produce lifetime income, making it a more desirable product for those who are unsophisticated or lack self-control. Psychologically, it would also facilitate the formation of private rules to use the accumulation to provide lifetime income. The only private rules suggested by the current penalty provision is to live to at least age fifty-nine and then spend the accumulation in any way the policyholder desires or die and leave it to heirs.[264]

One final possibility is to penalize non-annuity distributions by reducing policyholders' investment in the contract—the amount they may recover tax-free—if they take distributions in any manner other than a life annuity. Under current law, policyholders' investment in the contract includes all premiums paid, even though a part of those premiums are used to pay the insurance charges related to the guaranteed pay out rates and annuity death benefits. To encourage life annuitization, their investment in the contract would be reduced by those charges if they choose any distribution scheme other than a life annuity. To avoid administrative burdens, rather than tracing the actual insurance charges levied under each contract, the statute could provide for a reduction in basis of 1.25 percent per year (the average insurance charges). If an annuity were in accumulation over a long period of time, the cumulative reduction in basis would be very substantial and would provide a strong incentive to annuitize.[265] However, if the penalty applied to any distribution other than

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264. Even more extreme would be extension of the penalty coupled with some minimum distribution requirements like those applicable to qualified retirement plans. Qualified plans generally require that minimum distributions begin no later than age 70 _ and are designed to exhaust the balance in the account over the life expectancy of the participant. *See* JEFFREY R. BROWN ET AL., TAXING RETIREMENT INCOME: NONQUALIFIED ANNUITIES AND DISTRIBUTIONS FROM QUALIFIED ACCOUNTS, (Nat'l Bureau of Econ. Research, Working Paper No. 7268, 1999). The minimum distribution rules were recently changed to provide more flexibility in the designation of beneficiaries, reduce significantly the amount of the required distributions for many individuals, impose an enforcement mechanism, and simplify administration. *See* Mark J. Warshawsky, *Further Reform of Minimum Distribution Requirements for Retirement Plans*, TAX NOTES 297 (April 9, 2001). However, it is not clear what minimum distribution requirements would be appropriate for nonqualified annuities, and such a requirement would add to the administrative cost of the annuity, as it has with qualified plans.

265. Such a provision was part of President Clinton's fiscal 1999 budget proposals. That proposal would have reduced basis unless the policyholder annuitized at the guaranteed rates in the policy. Those guaranteed rates are so conservative that it is unlikely they will ever be used, so the budget proposal would have penalized nearly all policyholders. *See infra*, Part III. Life annuitization at either the guaranteed rates or at current rates should be sufficient to avoid the penalty if its purpose is to encourage annuitization.

a life annuity, it would unfairly penalize policyholders who purchase deferred annuities with every intention of eventually annuitizing but who later ascertain that their life expectancies are substantially shorter than average, perhaps due to the development of chronic illness. To address this legitimate concern, the adjustment should also not apply to annuitization for a fixed term equal to the actuarially computed life expectancy of the policyholder.

d. Restricting Annuity Death Benefits

Even the basic return of premium death annuity benefits may be vastly overpriced, and all of the enhanced death benefits are extremely complicated and irrationally priced. Whether any of them are reasonably priced, even in the aggregate, is a question the actuaries can't definitively answer. Enhanced death benefits may also induce less than optimal investment behavior and may provide strong incentives not to annuitize.[266] Only the basic return of premium death benefits should be allowed.[267]

To be fair to life insurance companies, some mutual funds are offering similar coverage as a selling tool for their products, and the insurance companies selling annuities feel they are in competition with mutual fund companies in attracting savings for investment. However, mutual funds offer it as a separate term life insurance benefit that is excludible from the beneficiary's gross income. Furthermore, if annuities are so close economically to non-annuity mutual fund investments that they do not have sufficient distinguishing characteristics to permit them to be marketed effectively without mimicking mutual funds, what does this say about whether they should be granted the special tax status they now have?

Analogous to the carpenter whose answer to every problem is to pound in another nail, the answer for an insurance company to every competitive problem with respect to deferred annuities has been to add another

266. While it may be puzzling why a policyholder would purchase such a bizarre form of life insurance, the insurance company has a clear motive for the current design of this benefit. IRAs and other qualified tax plans are prohibited from investing in life insurance contracts. IRC § 408(a)(3) (2002). If the nonqualified deferred annuity had a separate term life insurance benefit, it could not be sold to qualified plans, which currently represent over half of the market for them. The companies could sell the currently designed deferred annuity to qualified plans and design another annuity with a separate term life insurance benefit for other sales. It would be difficult, even embarrassing, to try to explain why the death benefits on the two annuities were differently priced and differently treated for income tax purposes.

267. To prevent insurance companies from encouraging policyholders to exchange annuity policies to obtain a higher death benefit, the return of premium death benefit should not be stepped up to the cash value of the policy when one policy is exchanged, as is the current industry practice.

expensive layer of insurance. Annuity death benefits are a good illustration of competition that has caused the consumer more harm than good.

e. Lowering Tax Rates on Annuity Income

The current industry proposal for encouraging annuitization is to tax the income element in an annuity payment at capital gains rates rather than ordinary income rates.[268] A taxpayer in a 15 percent tax bracket would instead pay 10 percent; while a taxpayer in a 30 percent or higher tax bracket would instead pay 15 percent. It seems unlikely these mild reductions in the tax rate on the annuity income would be sufficient to overcome the very strong resistance to voluntary annuitization, particularly if it is due to loss aversion. The fact that the tax benefit is of greater value to a person in a higher tax bracket is also troublesome. Lower income individuals, who are likely those with the lowest amounts of other sources of annuitized income, are those who would reap the greatest welfare benefits from additional annuitization and who need the greatest incentive to annuitize.[269] Yet this proposal provides them with the least additional incentive.

Merely adding an additional tax benefit at the annuitization stage of a deferred annuity will not do anything to deter purchasers who value the product primarily for its tax deferral aspects or deter marketing the product to purchasers for whom it is an unsuitable investment. Additional tax benefits without other design changes will not produce an optimally designed deferred variable annuity.

3. Enhancing Savings and Investment Aspects

a. Limitations on Contributions

One recurring proposal is placing limits on allowable contributions to nonqualified deferred annuities.[270] All other tax advantaged retirement savings plans have some limit on contributions, which strengthen their commitment aspects by making it harder to backslide or procrastinate and

268. *See supra* note 145 and accompanying text.

269. BROWN & WARSHAWSKY, *supra* note 19, at 38. Individuals with moderate amounts of assets who are likely to qualify for welfare or other government assistance if they outlive their assets have the least incentive to voluntarily annuitize their assets. *Id.* In fact, they may have an incentive to spend their assets quickly in order to qualify for government assistance. *Id.* Mandatory annuitization under the current Social Security system in this country and mandatory pension annuitization requirements in the United Kingdom are aimed at curing this moral hazard problem. *Id.*

270. *See, e.g.*, Carol V. Calhoun, *Tax Law and the Nonqualified Variable Annuity*, 41 TAX LAWYER 765, 772 (1988).

catch up with larger contributions later. A contribution limit would also put an upper limit on the amount that that could be sheltered in a deferred annuity by persons who have no intention of annuitizing, such as the wealthy or those who already have other adequate sources of annuity income from qualified retirement plans.

Contribution limits on deferred variable annuities are probably not sound policy. Certainly, we don't want to discourage a beneficiary of a life insurance policy who has suffered the loss of an income generating family member or the seller of a business who must use the cash proceeds to finance retirement from investing the life insurance benefits or sales proceeds in an annuity to manage their assets and insure a steady flow of income. Many annuity purchasers fall into those categories and would very likely be adversely affected by binding limits on contributions. The lack of contribution limits for nonqualified annuities is also likely to be "especially important in the common situation where a household finds itself approaching retirement with relatively little accumulated wealth and it needs to build up a substantial nest egg over a relatively short period of time."[271]

Because any acceptable contribution limitation provision would likely be subject to so many legitimate exceptions that it would be burdensome and costly to administer, avoiding limits would be preferable. Furthermore, limits on contributions would not address some of the more fundamental defects with the current design of the product.

b. Restricting Investment Choices

There is one other measure that would serve to distinguish deferred variable annuities from other investment options and strongly encourage the insurance industry to emphasize and promote the income options and long-term management aspects of annuities. That measure is to severely restrict the allowable investment choices in deferred variable annuities. It would substantially reduce the costs and increase the welfare benefits of the product with few, if any, unintended negative consequences.

The original CREF variable annuity for qualified plans provided for no investment choices; there was one diversified investment fund that was managed by CREF. The only choice the participant had was whether to maintain the variable annuity or transfer all or part of the accumulation to a fixed annuity. Transfers could be accomplished only by mail and only on the first day of a calendar month. It was not even necessary to price the

271. MICHAEL J. BOSKIN ET AL., THE ECONOMIC ROLE OF ANNUITIES 88 (Catalyst Institute Research Project, March 1998).

accumulation units daily since all contributions and distributions occurred only on the first day of a month. Once transferred to a fixed annuity, those amounts could not be transferred back to the variable annuity.[272] In other words, CREF made the product as simple as possible.

While investment risk was borne by the policyholder, the only investment fund was managed by CREF and provided virtually no choice to a participant except whether to commit retirement funds to the variable annuity. It worked quite well in that form for many years, and it was not until the 1980s that competitive pressures caused CREF to add more investment choices, adopt daily pricing, and provide more flexibility for transfers between CREF funds and between the variable and fixed annuity.[273] Whether this additional investor choice has substantially benefited the average participant is difficult to determine. Investing in the CREF retirement annuity is now more complicated, requiring significant additional educational efforts on the part of participating institutions in cooperation with CREF.

The original design of the deferred variable annuity dictated that the participant would rely on the investment expertise of the annuity provider. It was not contemplated that a variable annuity would become essentially a family of mutual funds covered by a veneer of costly and nearly impossible to value insurance, shifting not only investment risk but also investment responsibility to the participant. Whether intended or not, that is what has happened over the past fifty years. Over the past twenty years, the siren song of individual choice and autonomy, together with workplace and other broader societal changes, has brought about a similar shift in investment risk and responsibility from the employer to the employee in qualified retirement plans. Whether that is good policy and will result in greater individual welfare is still an open question. The unprecedented rise of financial markets from 1981 until early 2000 virtually stifled all dissent, but

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272. The original CREF variable annuity was available only for qualified retirement plans for employees of teaching and research institutions. As part of its retirement plan, an individual institution still has the right to impose similar restrictions on the accumulations of its employees, but none do. There was an exception for amounts paid into what are called supplemental retirement plans, which were required by law to be cashable. Amounts in supplemental plans could be transferred back from the fixed annuity to the variable annuity , only on the first of a month and through instructions by mail.

273. The investment choices now include four stock funds, two bond funds, one fund that invests in both stocks and bonds, and a money market fund. CREF now prices its funds daily and permits telephone exchanges. It also permits transfers from the fixed annuity to the variable annuity, only over a ten-year period. To transfer funds from a fixed annuity, the account holder is issued what is called a transfer payout annuity (TPA), which is essentially a ten-year term certain annuity. Annuity payments for the ten-year term are computed with a conservative guaranteed rate, but TIAA credits additional dividends to each year's payment based on its investment experience, making the TPA a participating annuity.

the prolonged market downturn over the past three and a half years has starkly illustrated the risks inherent in the transition. Many individuals made bad investment decisions that will have far reaching ramifications, and individual investor autonomy seems a lot less alluring now.

Over the years, the Internal Revenue Service has issued warnings that too much investment choice in a deferred variable annuity might result in unfavorable tax treatment, but it never issued regulations quantifying its precise position on how much choice is too much. Perhaps it determined that any bright line test would be too easy to game, while an amorphous "investor control" doctrine with uncertain contours would be sufficient to cause a rational and historically conservative insurance industry to police itself. If that was their assumption, history has certainly not proved them right.

There are several cogent policy reasons why significant restrictions on investor choice should be required as a condition to tax advantaged status of a deferred variable annuity. First, severely restricting investment choices will discourage the purchase of deferred variable annuities by those who are primarily interested in using them as a tax deferred active trading vehicle and will provide enhanced welfare benefits in the long run for policyholders who do purchase them. The evidence is very clear that the quest to find the superior fund that will consistently beat the market averages and the constant shifting of accumulations into last year's hottest funds, although psychologically appealing, are overwhelmingly losing propositions. The best investment strategy for retirement savings is a low cost portfolio made up of broadly diversified funds held for the long term. Active investors and short-term traders, who are convinced that have the ability to consistently beat the market averages, would tend to avoid any investment vehicle that severely restricted investment choice.[274] Thus, taking advantage of investor psychology, an excellent investment product can be designed that those interested primarily in tax deferral would not purchase.

Second, annuities should be designed to be appropriate for a broad range of individual investors with varying degrees of sophisticatication and for those households nearing retirement age with insufficient assets, who

274. Anecdotal evidence suggests that it is only a small number of variable annuity policyholders who account for the exchanges between subaccounts, and they tend to be the policyholders with the largest accounts. Kenneth P. Mungan et al., Session 113PD The Impact of Policyholder Behavior on Variable Annuities, Panel Discussion Before the Toronto Spring Meeting of the Society of Actuaries (June 20-22, 2001), *in* 27 RECORD No.2 at 5-6. The results are based on a sampling of exchanges between variable annuity subaccounts at Nationwide Insurance Co. from December 2000 through February 2001. *Id.* The survey also disclosed that policyholders who had purchased from a broker are more likely to engage in exchanges than policyholders who purchased from an agent. *Id.* at 6.

likely arrived at that point through some combination of lack of self-control and inability to plan and implement long-term savings and investment programs. These are the groups most often mentioned in policy debates as likely purchasers of annuities, but they are more likely to benefit from narrowly focused savings programs than those providing a bewildering array of investment choices. More choices increase the deliberation costs of making optimal investment decisions and increase the possibility of costly investment mistakes. Avoiding costly mistakes is particularly important for those who find themselves nearing retirement with few assets since they may be inclined to take undue risks to catch up more quickly, and they have very little time to recover from them. Investors who wish to "roll the dice" should not be provided a tax-advantaged vehicle that facilitates or encourages such potentially destructive behavior.

Reducing the number of subaccounts and simplifying them will also greatly simplify the annuitization decision. If policyholders choose variable rather than fixed payments on annuitization, they must also choose which of the various subaccounts in which to annuitize. Too bewildering an array of choices may lead to decision overload and inhibit variable annuitization even though it has substantial potential welfare benefits. There are also serious questions whether volatile sector funds, such as those concentrating in technology, precious metals or energy, are ever appropriate to back variable pay outs, whatever limited value they may have during the accumulation phase.

Severely restricted investment choices would make the product more appropriate for all purchasers without impairing its utility. Since the product would likely be most attractive to purchasers who are unsophisticated or who have self-control problems, the redesign would give insurance companies greater incentive to advertise and market the product to that segment.

Third, from a behavioral point of view, unlimited investment choice is often detrimental. Whether intended or not, the menu of fund choices subconsciously shapes the investment strategies of policyholders in ways not intended by the companies. As the research with respect to investment choices in 401(k) plans indicates, some investors tend to view the menu of choices as the advice of "experts" concerning appropriate asset allocation strategies.[275] Too many choices, particularly choices that are complicated and difficult to assess, may result in procrastination and can often result in naïve diversification strategies. Too many choices also facilitate the potentially disastrous tendency of individual investors to trade too much

275. *See supra* note 224.

and consistently move money into last year's best performing funds rather than maintain a consistent long-term investment strategy.

Fourth, a redesigned deferred variable annuity with restricted investment choices, particularly if coupled with limited death benefits and extension of the penalty provisions, would be a suitable investment for many more individuals that value both its investment and annuity aspects but who are hesitant to purchase the current product due to its complexity and high cost. The redesigned product would be much more difficult to sell to unsuitable purchasers because it would be clearly differentiated from other taxable investments. Tax efficient equity investing outside of an annuity is most often superior to equity investment in a deferred annuity, particularly in the case of older individuals who have no intention of taking advantage of the annuity pay out options. The current design does not distinguish the deferred variable annuity clearly enough from other investments like mutual funds, making it too easy to market them to purchasers for whom they are inappropriate investments. A redesigned annuity will effectively deter those practices without adversely affecting the utility of the product for its legitimately intended purposes.

Fifth, the resulting simplification of the product, particularly if accompanied by elimination of most death benefits, would have several very desirable behavioral effects. Targeted tax benefits are effective in altering behavior when they facilitate focus on particular issues. Under current law, no focus is required, and the majority of insurance companies have designed a product that is focused neither on annuitization nor on any particular manner of saving or investing for retirement. Severely restricted investment choices coupled with elimination of all but a basic death benefit would greatly simplify the product and substantially reduce its costs, blunting two of the major criticisms of the product as it is currently designed. Since insurance companies will have to spend less of their time and advertising money trying to counter legitimate negative assessments of the product, they will better be able to focus their efforts on marketing an attractive product. A simple, more focused product will be easier to advertise and sell to suitable purchasers. In short, it would satisfy the two requirements of a good savings plan: that it be simple to understand and use and that it be judged sound by the experts.

Sixth, severely restricted investment choices would serve to more clearly differentiate the nonqualified deferred annuity from other tax advantaged retirement savings plans, such as IRAs and 401(k)s. The less a nonqualified deferred annuity is perceived as an easy method to "catch up" for failure to utilize those other tax advantaged plans, the less likely its existence will facilitate procrastination in implementing retirement savings.

If the "catch up" method provides significantly less freedom of investment choice, it will not be seen as an attractive substitute for those other plans, which may cause an increase in their utilization.[276] Because the welfare benefits of early and consistent saving through IRAs and 401(k)s are significant, policies designed to discourage such procrastination are highly desirable.

Lastly, restriction of investment choices will encourage insurers to compete on the basis of the annuity aspects of the product. Competition will produce more innovative and attractive payout options, making it more likely that the purchasers will eventually annuitize their accumulations even if they are not required to do so. For example, if the resistance to annuitization is a rational one based on legitimate concerns over illiquidity, then perhaps the best solution is to trust the marketplace to design appropriate products that address liquidity concerns, as has already occurred with respect to long term care expenses.[277] Much like the nondiscrimination requirements of 401(k) plans have encouraged firms to be highly creative in promoting participation by moderate income employees, encouraging the industry to compete on the basis of the payout features of an annuity can have similar beneficial effects. Shifting the focus of the product from merely an alternative investment accumulation vehicle to a payout vehicle may also have positive psychological effects. If the account is mentally classified as an annuity rather than as merely another asset account, there may be greater likelihood of ultimate annuitization.

How restricted should the investment choices be? Assuming that ultimate annuitization is not required, the investment choices should be very restricted because that aspect must function as the primary deterrent to purchase of an annuity primarily for tax deferred active investment purposes, to make it a suitable investment for large numbers of individuals with differing degrees of sophistication, and to reasonably insure it cannot be effectively marketed to purchasers for whom it is unsuitable. The restrictions should not be so severe that they substantially impair the investment aspects of the annuity. No more than about a half dozen should suffice: a fund that tracks the entire United States stock market, a global equities fund, one or two bond funds, a balanced fund investing in both stocks and bonds, perhaps a real estate fund, and a money market fund. Where possible, the funds should adopt a passive, indexing approach to minimize costs. No sector funds or other specialty funds should be

276. *See supra* note 203 (discussing psychological evidence).

277. BROWN & WARSHAWSKY, *supra* note 19, at 36-37.

allowed. An annuity should be kept as simple and as suitable for all purchasers as reasonably possible.

There should also be significant restrictions on transfers between fund options to make the product even more inappropriate for market timers or speculators. Rather than attempting to define an optimal number of transfers and impose that limit by statute, a more administrable solution would make excessive transfers taxable transactions. For example, one exchange or simultaneous series of exchanges among the subaccounts may be allowed each year to permit the annual rebalancing of a portfolio; while any further exchanges would be treated as immediately taxable.

Had the industry exercised more judgment and discretion rather than conducting a competitive race to the bottom, then the imposition of such restrictions would not be necessary. It is not an adequate answer to say that a few companies have been responsible and have resisted the urge to join the competitive race. The marketplace noise created by those companies that did not take the high road is deafening, making it difficult for those other companies to gain any significant market share. More important, the fact that there are some well designed deferred variable annuities worthy of the name should not permit other companies to market a tax advantaged product to purchasers for whom it is often an unsuitable and unwise investment.

If investment choices were severely restricted, so that the deferred annuity were clearly differentiated from other investments like mutual funds, then providing special income tax rates for the gain in life contingent annuity payments chosen under deferred variable annuities would be more acceptable since it is more likely that the additional tax advantage would be used to encourage annuitization rather than as merely another selling point to gain competitive advantage for deferred annuities as an attractive investment option to mutual funds.[278] Since such a redesigned product would probably not be particularly attractive to higher income individuals who have other significant sources of retirement income, the tax benefits would more likely be targeted to moderate-income individuals.

278. If encouraging annuitization is the goal, perhaps individuals with assets accumulated in taxable accounts outside of deferred annuities should also be allowed to transfer them without recognition of gain to purchase immediate annuities. If that were allowed and the annuity gains were taxed at capital gains rates, individuals might be more willing to use investment assets with unrealized capital gains to purchase annuities. Whether such transfers should be permitted to deferred variable annuities is a harder question since the primary purpose for such a transfer might be merely the desire to change investments without immediate taxation of the gains. If the deferred variable annuity were redesigned as proposed in this article, that would be less likely.

4. *How Likely is it that Congress Would Impose Investment Limitations?*

While the Service has long considered itself to have the authority to define how much investor control an insurer may legitimately cede to the policyholder,[279] the type of investment restrictions suggested here would require legislation.

Given the clear trend toward more investor autonomy in retirement plans and the current debate over whether to extend that policy to the Social Security system, how likely is it that Congress would amend the statute and impose severe restrictions on investment choice in deferred variable annuities? Three and a half years ago, when the equity markets were

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279. In the preamble to the temporary and proposed regulations published in 1986 concerning the fund diversification requirements, the IRS stated that formal guidance on the investor control issue would be forthcoming, but none has yet been issued. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:56. The first ruling approving a variable annuity separate account involved a single segregated asset account with no subaccounts that was invested solely in a mutual fund managed by the insurance company or its affiliate. Rev. Rul. 81-225, 1981-2 C.B. 12, 14. Later published rulings went further but involved only a very small number of funds, typically not much more than a stock fund, a bond fund, and a money market fund. *See, e.g.*, Rev. Rul. 82-54, 1982-1 C.B. 11. In 2003, the Service published a ruling that mentioned an annuity backed by twenty mutual fund choices and once-a-month transfers between funds, but gave no indication why it viewed twenty fund choices as acceptable or whether annuities with more than twenty fund choices. Rev. Rul. 2003-91, 2003-33 I.R.B. 347.

The Service has never clearly articulated any basis for its position that solely too many choices among otherwise acceptable subaccounts might constitute prohibited investor control. It always based its investor control position on the technical legal issue that too much control would cause the investment accounts to be treated as owned by the investor rather than by the insurer. The only suggestion for a doctrinal basis has been the substance-over-form principle of tax law. ANNUITIES ANSWER BOOK, *supra* note 27, at Q 6:56.

It is a curious position and one that never seems to surface with respect to other tax advantaged retirement plans, particularly qualified plans such as IRAs and 401(k)s. There are very few restrictions on permissible IRA investments, and while the number of investment choices in many 401(k) plans is limited, they may have even more extensive menus than the typical variable annuity. The Investment Company Institute reported that the median number of investment options in 401(k) plans in 1998 was six; while Hewitt Associates reported that the median was nine. Engen & Lehnert, *supra* note 17, at 803 n.25. Since a 401(k) plan is an employer plan, the employer determines the available investment options.

The investor control issue has also not been advanced with respect to nonqualified salary deferral plans. A nonqualified salary deferral plan is an agreement with an employer to pay part of the employee's salary in the future. So long as the plan does not set up a separate fund for the employee that cannot be reached by the employer's creditors, the cash method employee reports the income when he or she actually receives it, even if the deferred amount is invested and the amount ultimately paid will include investment gains. *See* Rev. Rul. 60-31, 1960-1 CB 174, 178. The employer may set aside the deferred amounts into an actual account, commonly called a "rabbi trust," that it invests in securities, so long as the account is subject to the claims of its creditors. Currently, many companies provide expansive investment choices for the deferred amounts, and employees may redirect the amounts from one investment fund to another. Perhaps the IRS is unaware of the fact that these plans allow choice or the range of choices being offered, but they have raised no challenges thus far to the deferral of salary under these plans on the ground that too much choice will result in the employee being treated as the owner of the funds and therefore currently taxable on them.

soaring and anyone who invested in the stock market was on her way to a comfortable retirement at age fifty, the chance might have been near zero. In today's difficult investment environment, the complexities and risks of investing have become much clearer. To its credit, the federal government has demonstrated that it knows the elements of a sound savings and investment program; it chose a program for its own employees, the Thrift Savings Program,[280] which is almost identical to the one this article proposes for deferred variable annuities. In appropriate circumstances, the proper function of government is to stand against the prevailing winds and adopt sound policy, even if it may be unpopular.

C. SUMMARY

Accepting the fact that insurance companies are able to provide very valuable income options and long-term asset management and financial planning assistance during both the accumulation and the payout phases, the task is to design a deferred annuity that will accentuate and facilitate those aspects. What is clear is that the current design—essentially leaving almost all substantive decisions up to the industry—is not calculated to accomplish that goal and has not been successful in doing so. The special tax status of deferred variable annuities gives them an important competitive advantage over other forms of nonqualified retirement savings, but that advantage has been misused by the insurance industry to define and market a product that is needlessly complex, overly expensive, and unsuitable for a large number of individuals who purchased them. Without design requirements imposed on them, the industry will continue to emphasize only those aspects of the annuity that are the easiest to sell rather than the ones that are most valuable from a public policy standpoint and most suitable for use by large numbers of participants with varying degrees of sophistication.

If investment options were severely restricted, penalties for non-annuity distributions were extended, and all but a very basic death benefit were prohibited, then sound asset management and creative and attractive income options would be the only aspects of deferred annuity design that could be competitively exploited by insurers. The extremely competitive annuity marketplace would provide the industry the incentive to enhance those aspects of their deferred annuities, resulting in significant welfare gains and quite possibly including an increase in annuitization rates. It is the best prescription to encourage annuitization short of a mandate to

280. *See supra* note 122 (explaining the Thrift Savings Program).

annuitize, and it avoids the significant administrative costs and unintended consequences of such a mandate.

Critics may respond that these proposals will destroy the market for deferred variable annuities. There is no doubt they will make the product much less attractive for those purchasers who have no interest in anything other than a tax-sheltered investment vehicle. If the desired results from the proposed design changes do not materialize and the market for deferred variable annuities does wither and die, then it should; if promoting and enhancing long-term retirement asset management and attractive income options—the only aspects of a deferred annuity that can properly distinguish it from any other nonqualified retirement savings plan—do not make it an attractive product, then it should die a quick and natural death.

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